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Accounting Questions: Goodwill, Real-estate appreciation, and Valuation of Stocks

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Accounting Questions

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GOODWILL, REAL-ESTATE APPRECIATION AND VALUATION OF STOCKS

Question: Corporation X. Y. Z. was formed under laws of New York in 1925, with 5,000 shares common stock, par value $100.00, and 2,000 shares cumulative 7% preferred, par value $100.00. The corporation was formed to take over the business carried on by A as an individual, and all the stock was issued to A for the net assets of his business.

The total net assets were $600,000 and the total par value of the stock issued was $700,000. To make up the difference real estate was increased $15,000 on the books and goodwill was set up on the books at a value of $85,000.

At June 30, 1935, securities purchased by the corporation at various times, and carried on the books at cost, had a market value of $70,000 less than their cost.

A died June 30, 1935. On that date there was an earned surplus of $125,000 and no unearned surplus. No dividends had ever been declared or paid on either common or preferred. At the time of his death A owned all the preferred and 4,000 shares of common. Employees owned 800 shares of common, and the other 200 shares had been purchased by the corporation from an employee and were in the treasury.

After A's death the directors of the corporation, one of whom is an executor under A's will, charged off the goodwill of $85,000 and the real-estate appreciation of $15,000 against surplus as of June 30, 1935.

Is this a proper charge against earned surplus? If not, what entries should be made to take these two items out of assets?

In determining the separate values of the common and preferred stock for the purpose of inheritance taxes what consideration should be given to the unpaid cumulative dividends on the preferred stock?

Answer No. 1: We assume that the items of $85,000 for goodwill and $15,000 for real estate were merely book entries to equalize the par value of stock issued by corporation X. Y. Z. to "A" and represented inflation of capital values. By due legal process and full disclosure, a reduction in capital may be obtained to provide sufficient capital surplus to absorb the charge-offs at "A's" death. Unless this be done the amounts in question must be charged against the earned surplus.

The question relates to the "value" of common and preferred stock for the purpose of inheritance taxes and does not relate to book value.

The true "value" would appear to be the fair market value to an actual buyer if such a buyer were available.

The value of the preferred and common stocks for inheritance-tax purposes should be based upon the earning power of the company, subject to the realizability of the assets in excess of the values computed upon an earning basis. In the present case it would appear that the values of the stocks are substantially less than the book values applicable to each class of stock.

The books of the X. Y. Z. company are only prima-facie evidence of the value of the stock. The entries charging off the goodwill and real-estate appreciation have no bearing on the value of the stock.

Additional information pertinent to the case would appear to be required. The following points should be covered:

(1) The nature of the business.
(2) The effect of the death of "A" upon future of the company.
(3) An analysis of the earnings by years to establish the trend of earnings and the effect of the depression during later years.
(4) An estimate of future earnings.
(5) An estimate of the present actual value of the real estate, compared with its assessed value, and any information as to current real-estate sales.
(6) Data as to any obligations such as mortgages on the plant.

In view of the fact that the company has failed to earn the dividends on its preferred stock over a period of ten years, although the earnings have been retained by the company for use in its operations, there would appear to be no goodwill value.

The accumulated earned surplus of $125,000 represents average earnings of (say) $12,500 per annum, while the unpaid cumulative preferred dividends amount to (say) $140,000 or $14,000 per annum. The earnings represent approximately 6% on the preferred stock.

Unless the assets of the company have a present realizable value sufficient to pay the liabilities and liquidate the preferred stock, together with unpaid dividends thereon, and leave a surplus for the common stock, and provided that the future earnings are not expected to be materially increased, the common stock would appear to have only a speculative value and the preferred stock would have a value based upon an earning capacity of 6% per annum, after taking into consideration the nature of the business, the stability of the company and its future prospects. A rate of 12 per cent. to 15 per cent. may be suggested as a fair rate to apply to average earnings in order to find the value of the preferred stock.

Answer No. 2: We believe that the goodwill of $85,000 and the real-estate appreciation of $15,000 may be properly charged against earned surplus by the directors, provided there is nothing in the bylaws to forbid the directors to take such action without the approval of the stockholders. In valuing the capital stock for inheritance-tax purposes, however, other factors would have to be considered. In the case of a close corporation, such as this, where no market quotations for the stock are available, book value is frequently used. In computing the book value, however, the assets should be valued at fair market values to a going concern at the date of death and a fair value for goodwill should be determined. In the case given the available information would indicate that the goodwill has no value.

Regarding your second question concerning the consideration to be given to unpaid dividends on the preferred stock, we believe that full consideration should be given. Assuming that dividends have accrued from June 30, 1925, the arrears would amount to 70% and the preferred stock would, therefore, be valued at $170 a share, while the value per share of the common stock would amount to 1/4800 of the excess of the total net worth of the business over $340,000. The net worth for this purpose would be computed by using market values for assets as previously mentioned.

The answers given above might be greatly affected, however, by other factors which are not disclosed in the problem. Two important such factors which might have a bearing upon the valuation of the net worth of the company are the future earning prospects and also the effect which "A's" death will have upon the operation of the business.

Answer No. 3: If the action of the board of directors was taken for the purpose of reducing the book value of the shares at June 30, 1935, for inheritance-tax purposes it will be necessary to provide evidence to satisfy the exacting requirements of the state and federal authorities to support the action of the board.

Writers differ on the propriety of asset write-offs against earned surplus. In view of the facts as presented we feel that

1. Assuming par as the cost of the 200 shares of common stock acquired from an employee, $20,000 should have been segregated from the earned surplus of $125,000. (This procedure is required only in certain states.)
2. Provision should have been made out of earned surplus at June 30, 1935, for the decline in the market value of the securities purchased since the organization of the corporation.
3. Assuming that conditions existing at June 30, 1935, support such action, the book value of the real estate may be reduced by a charge to earned surplus.

Assuming the advisability of the write-down of goodwill, the resulting earned surplus would then not be sufficient to permit the charge-off of the goodwill. To supply the deficiency, capital surplus can be created by a transfer from capital stock, by a reduction of the par value of the present shares, a change from par to no-par shares, a stock donation by owners, or a reduction in the number of shares. In this case if the earned surplus were $250,000 instead of $125,000 we would consider the charge-off and write-down proper.

As to the valuation of the common and preferred shares for the purpose of inheritance taxes, we feel that the consideration to be given unpaid accumulated dividends on the preferred stock depends upon the rights and privileges attaching to the two classes of stock according to the charter. If the charter provides that upon liquidation the holders of the preferred shares are to receive par and all unpaid accumulated dividends, then, in our opinion, the value of preferred stock should include the amount of such unpaid dividends. It should be noted that the federal estate-tax form, schedule B, requires that "inactive stock and stock in close corporations should be valued on the basis of the company's net worth, earning and dividend-paying capacity and all other relevant factors bearing on the value of the stock." In this case a study of the history of the company would have to be made to determine which basis or combination of bases should be used in valuing the common stock. It is assumed for this purpose that these preferred and common shares have no active market.