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Students' Department

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Students' Department

EDITED BY SEYMOUR WALTON
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PROFITS AND DIVIDENDS

Many accountants have taken the position that some classes of profits must not be credited to surplus, because they are not available for dividends. Some go so far as to say that dividends cannot be paid except from those profits which are the results of operations of a normal and regular character.

In the discussions of this question much confusion has arisen from the use of the word "should." In treating of the right of directors to pay dividends out of contributed surplus, it is often said that they should not do so. Whether intended to be so construed or not, it is undoubtedly true that the statement is generally understood to mean that the directors could not legally pay such dividends. It may have been intended to mean only that the directors are morally bound not to deceive the stockholders and, therefore, ought not to mislead them by tacitly allowing them to think that a dividend had been paid out of earned profits, when it actually came out of the surplus paid in by the stockholders themselves.

In determining the earning power of a business only those profits are to be considered which are the result of the normal operation of the enterprise, and in stating those profits only those elements are to be included which are necessary to the operations. Since it is not essential to a commercial enterprise that it should borrow or lend money, interest is not to be classed as an operating expense or profit. Cash discount would be subject to the same ruling unless it is treated as a reduction of price instead of a financial item similar to interest. Bad debts are also excluded from the operating expense, both on the ground that they are the fault of the management and not of the operating departments, and because they are theoretically not essential to any business.

There are then expenses and profits which are not part of the operations of a business, strictly speaking, and yet, as every one will admit, they affect the final profits out of which dividends are payable.

One source of profits outside of normal operations is the sale of fixed assets for more than was paid for them. When land is the only asset sold, the increase in the price realized is, without any doubt, an extraneous profit to which operations have contributed nothing. But when buildings are included, or any other assets on which depreciation has been regularly charged off, such as horses and wagons, the situation may be complicated. If an account has been kept with "land and buildings," with a reserve account to which has been regularly credited the depreciation on the buildings, and all the real estate has been sold for a price in excess of the book value, there are two possible explanations of the excess.

Each asset may have realized more than its book value.

One asset may have realized more and the other less than its book value, the difference, of course, being the excess of the whole amount realized over the book value of the combined account.

To illustrate: suppose land cost $25,000 and buildings $75,000 and there is a reserve for depreciation of buildings of $30,000, the net carrying value of land and buildings would be $70,000. If they are now sold for $85,000, there is an apparent profit of $15,000. To determine where the profit is made it will be necessary to separate land from buildings, not only in the account but also in the sale. After charging $30,000 to reserve for depreciation and crediting it to buildings, the terms of the sale are analyzed to find that the land was valued at $35,000 and the buildings at $50,000. The result of the sale would therefore be:

Book value, land	25,000	Realized	35,000	Profit	10,000
Buildings	45,000	"	50,000	" (?)	5,000
	70,000		85,000		15,000

On the other hand the analysis of the sale may show that $45,000 was allowed for the land and only $40,000 for the buildings, the result being:

Book value, land	25,000	Realized	45,000	Profit	20,000
Buildings	45,000	"	40,000	Loss	5,000
	70,000		85,000	Net profit	15,000

In the first case the increased value of the land is, without any doubt, a realized profit, but the excess of $5,000 attributable to the building is not. It must be remembered that the depreciation reserve set up was based entirely on an estimate. Therefore the carrying value of the buildings at $45,000 was merely the judgment of some one as to their present worth. The realization of $50,000 for them proves that the judgment was at fault, and that too much depreciation has been allowed. The charging off of $5,000 more depreciation than had actually been suffered has reduced the operating profits in the past and this reduction has been reflected in a corresponding reduction of the surplus. To correct the error the regular surplus account must receive the credit, whatever the disposition made of the $10,000 increase in the land.

In the second case the same reasoning would make necessary a charge to regular surplus to correct the deficiency in the past charges for depreciation, and the extraneous profit to be dealt with would be $20,000 instead of the net, $15,000. This would be subject to change, however, if it were decided that the depreciation in the past had been correct for a going business, and that the present loss on the buildings had been taken in order to secure the profit on the land. The loss may not be due to depreciation, but to the fact that expensive alterations may be necessary to fit the requirements of the purchasers. In this event, the extraneous profit would be the net $15,000.

Another source of extraneous profit or surplus is that which is contributed by the stockholders. This is sometimes done at the inception of a corporation by paying in more than par for the original stock. The only way in which this surplus can be so fixed that the directors cannot pay dividends out of it is by having it made a condition in the original subscription that no part of the contributed surplus shall be used, directly or indirectly, for the declaration of dividends. This would take it out of the power of the directors, but it would still be possible for the stockholders to rescind their action and allow the distribution of the surplus.

The advice is often given to auditors to insist upon the putting of such surplus into an account that will show its true character, such as "contributed surplus" or "surplus unavailable for dividends." There is no question that this would be advisable, but the reason is that stockholders, having become accustomed to seeing the item in the balance-sheet, will inquire why it has disappeared or been reduced. The reason is not the one usually given—that it will prevent the directors from using it for dividends—because, in the absence of a contract with the stockholders, the directors can, at their pleasure, reverse their action and transfer the whole amount to ordinary surplus, where it will be available for dividends.

One class of contributed surplus is unquestionably to be credited to the regular surplus account where it is available for dividends to exactly the same extent as the surplus earned by operations. This condition occurs when the outstanding stock of a company that already has a surplus is increased either by the sale of treasury stock or of a new issue of shares. Suppose that a company has a capital stock outstanding of $10,000 and a surplus of $10,000, and that an outsider wishes to turn in property at an agreed valuation of $20,000 for additional stock to be issued. It would be manifestly unfair to sell the newcomer $20,000 at par, for he would then own two-thirds of a net worth of $40,000 (capital $30,000, surplus $10,000). This would give him an interest worth $26,667 for which he had paid only $20,000 and would reduce the holdings of the old stockholders from $20,000 to $13,333. Unless the old stockholders first declare and issue to themselves a stock dividend of 100 per cent., the newcomer must be given stock for a par value of $10,000, and surplus must be credited with the other $10,000. This is contributed surplus, but by no possibility can it be classed with the surplus that is contributed by all the stockholders.

The object to be gained by the sale of the new stock is the doubling of the capital conditions of the company. Therefore the stock issued to the newcomer must be of exactly the same character as that held by the old stockholders. The old capitalization consisted of two elements, the capital stock of $10,000, and an equal amount of surplus available for dividends. For the newcomer to contribute capital stock of $10,000 and a surplus of $10,000 which is not available for dividends would mean that he has not exactly matched the old stock. After the sale the company must show a stock capital of $20,000 and a surplus of $20,000, and all of the latter must

be available for dividends. To argue otherwise would be to claim that there could exist differences between different shares of the same class of stock.

The question of an estimated profit arising from an appraisal of fixed assets at a figure above their carrying value when the excess value is based on market conditions alone is more complicated. On this subject R. H. Montgomery says:

"Many business men who secure an appraisal which sets forth that their buildings and machinery are, on the basis of a replaceable valuation less depreciation, worth more than they cost originally, wish to set up on their books and statements this diagnosis, and do not like to be told that they are making trouble for themselves. They have a larger valuation to wipe out by depreciation reserves, and thus, in a sense, they are increasing their cost of production. After a credit to surplus account is made it is most unlikely that any part thereof will be used except for dividends.

"The law on the subject of profits is not well settled, and will not be so long as the majority of lawyers retain their profound ignorance of accounts, but it is quite likely that no legal obstacle would prevent a corporation from revaluing part of its assets and applying the excess so raised to surplus available for dividends. With the law in such an unsatisfactory condition it remains for the professional auditor to educate the business public to the principle that it is not only foolhardy but unscientific to write up the value of an asset which is not for sale and which therefore cannot be represented by cash or its equivalent. Funds for dividends should be realized from the earnings, otherwise the working capital of the company is permanently depleted if a cash dividend is declared out of surplus created in the manner stated.

"There may be in exceptional cases an obvious rise in value of an item of fixed assets, but a footnote in the balance-sheet is all that is required to secure the benefit of an increased credit rating, and any adjustment of the account in the books by increasing the asset crediting surplus is rarely permitted by good accounting practice."

It is to be noted that Mr. Montgomery does not speak of land. In another place however, he says:

"Land should appear in the balance-sheet at cost, and should not be written up, although it may be clearly established that values have increased. As a matter of fact, an increment in the value of land usually means higher taxes, with no increase in earning power, so that the increased valuation is a detriment so far as current operations are concerned. The business does not receive any benefit therefrom except in case of a sale or a liquidation, and an adjustment of the book value need not be considered till these actually occur."

A. Lowes Dickinson says on this subject:

"It is necessary to recognize that there are causes at work, particularly in young and growing communities, which may render a statement prepared on the basis of cost of capital assets misleading and even pre-

judicial to the proper interests of present owners. Over a period of years changes in value due to rise or fall in prices may be sufficiently permanent to render it unfair to one business to maintain original cost values with another whose assets have been created at widely varying costs. Moreover, even where constructed works may have fallen in value owing to depreciation or obsolescence which has not been provided for, there may be an offsetting increase in the value of land and its subsoil or other natural products due to the development of the community and consequent largely increased demand. It is true that from the point of view of earnings such increment may not be taken as in any way a proper offset to losses due to wear and tear, depreciation or obsolescence; but this does not alter the fact that in spite of an insufficient provision of depreciation on some assets, there may be an actual increase on the total value of all assets. In fact, there are well-known cases in which by far the larger part of the ultimate profits of a corporation over a long series of years has been due not to the results of its activities but to the large unearned increment on its capital assets. This condition must be recognized and is frequently met by means of careful appraisals of all properties, the resulting increase (or possibly decrease) being taken up as a special credit or debit to profit and loss account (or surplus) and shown as entirely distinct from the operating results.

"In the case, too, of a sale of a portion of the capital assets it may be entirely legitimate to take up any profit just as it may be necessary to provide for a loss. This may be done by means of an appraisal of the property remaining unsold, the difference between this figure and the book figure, after deduction of the sale price of the portion sold, being treated as the estimated profit or loss arising on the sale and appraisal. This being divided proportionately to the sale and appraisal figures, the former will represent the approximate profit or loss on the sale. It is undoubtedly more conservative to treat profits so arising as a capital reserve available to meet possible losses from further sales or ultimate realization, while losses if clearly ascertained would be written off either at once against past surplus or by instalments against future earnings. There are, however, cases in which a surplus exists beyond all reasonable doubt and no objection can be taken to treating at any rate a substantial portion thereof as realized and divisible. It is always difficult to come to a decision as to the best treatment in cases of this kind; as in many others, each must be considered on its merits, with due regard to safety in finance and justice to the varying interests of present and future owners."

It is to be noted that Mr. Montgomery is much more emphatic in his condemnation of the writing up of fixed assets than is Mr. Dickinson. Neither of them brings out with sufficient clearness the folly of writing up the present value of assets subject to depreciation. Such an increase would be registered as a present profit or addition to surplus with the certain knowledge that it will be eventually lost through the increased charges for depreciation. Present profits founded on future losses are

not only unscientific—they are foolish in the extreme. No accountant should lend his sanction to such practice.

In regard to land there would be really more justification in writing up the value if there were any way to insure the permanency of the increased valuation. Real estate is subject to very violent changes in market price. When business is prosperous a good manufacturing site may command a price far in excess of its cost, but in hard times the same property may be almost unsalable. It is a very dangerous doctrine that a company may write up even a portion of an estimated increase in the value of land and may credit the amount to surplus. Mr. Dickinson's suggestion that the increase should be credited to a capital reserve will not meet with the views of the directors who wish to write up the land. Their object is to enhance the financial standing of the concern by increasing its surplus, even if they do not wish to declare dividends against the increase. If they wished only to show that they owned an asset much more valuable than its book value, it would suffice to have the balance-sheet show the large market value in a parenthesis, as Mr. Montgomery suggests.

If the directors insist upon writing up the value of land, an auditor should protest against the action, and should explicitly deny in his certificate that he assumed any responsibility for the valuation put upon that asset. How far the directors are personally responsible for paying dividends based solely on an increase in market value does not seem to be definitely determined, but there is at least one English decision which held directors responsible to creditors because they had paid large dividends based upon advance in market price of land which was not permanent. When the land reverted to its original market value the decline was sufficient to bankrupt the company so that it could not pay its creditors, and the directors were obliged to make up the shortage.

Dividends are payable out of profits, but those profits must be real and must not consist merely of a book entry. They must be represented by cash or by its equivalent which can be sold for cash or add actual value to the business as an operating enterprise. Land which cost $25,000 is no more valuable to the business because it is now supposed to be worth $50,000.

But if the profits are real and are represented by available additions to the business, they are no less profits because they do not happen to have been made in the normal operations of the business. To say that such profits are not to be credited to the regular surplus account and be available for dividends is as illogical as it would be to say that a loss on the sale of a fixed asset should not be charged to surplus and thus decrease the power to declare dividends. If the land that cost $25,000 has been sold for $15,000 no one will deny that $10,000 must be charged to surplus and not to "special deficit," but some accountants claim that if it sold for $35,000, the gain of $10,000 should be credited to "special surplus" or "special reserve" and that it could not be used for dividends.

The truth seems to be self-evident that a real profit is a profit, and that surplus is accumulated profit. When it is once decided that a profit is

real that is no alternative except to put it with all the other profits into the surplus account. Of course the officers and directors should not allow the stockholders to believe that any large increase in the surplus or in the dividend was caused by the normal operations, but that is really a question of morals rather than of accounting.

Those who claim that profits other than those from normal operations must be credited to a special account and cannot be used for dividends are curiously silent as to what will eventually become of the special account. If it is wrong to credit the amount to surplus at the time the asset is sold, it will be equally wrong ten, twenty or fifty years later. The account must hang, like Mohomet's coffin, between heaven and earth. It is like a mirage, very beautiful to look at, but utterly useless, because unattainable.

In following out such a theory a company that already had a working capital that was too large, if anything, would be obliged still further to increase it and to carry a large balance of idle cash, or at best invest in bonds bearing a comparatively low rate of interest. Stockholders who could use the money to better advantage if allowed to have it as a dividend would not have much patience with sophistries that are utterly contrary to all commonsense.

Another strange claim that is sometimes made is that extraneous profits, while not available for cash dividends, may be used as the basis for stock dividends. Such a claim indicates an entire misconception of the legal and accounting principles governing the declaration of dividends. The right to declare a dividend depends entirely upon the size of the surplus balance. The directors can declare a dividend to the full extent of that balance, provided, of course, that it is a legitimate balance, accumulated from real profits of whatever kind, and not one made up of fictitious profits prepared to deceive creditors or stockholders. What form the dividend will take depends entirely upon the judgment of the directors, guided by the financial condition of the company. There are no conditions under which it would be legally right to declare a stock dividend and wrong to declare one payable in cash. The possession or lack of available ready money would be the only determining factor, as a rule.

There is one condition under which the right to declare a dividend has never been discussed as far as we know. This condition occurs when a part of the earned surplus has been appropriated to cover a sinking fund for bonds, and the company has enough idle cash on hand to pay a dividend larger than the free surplus remaining. This condition is necessarily a very uncommon one, because the idle cash must have come from some other source than profits. It could not come from profits because the surplus account would always be at least as large as the amount of cash produced by the profit, and there would be no money available with which to pay a dividend greater than the free surplus. Suppose such a condition as the following:

Land not in use	100,000	Capital stock		500,000
Sinking fund bonds	150,000	Bonds		400,000
Other assets	950,000	Accounts payable		125,000
		Surplus:		
		Appropriated	150,000	
		Free	25,000	175,000
	1,200,000			1,200,000

The land not in use was originally purchased with the intention of using it for workmen's cottages and is not covered by the bond mortgage. This intention is now abandoned and the land is sold for $100,000 cash, there being no profit or loss in the deal. The working capital before the land was sold was sufficient, so that the directors find themselves after the sale in possession of $100,000 for which they have not the slightest use. Can they declare and pay a dividend larger than the $25,000 free surplus?

We claim that they can. There is no question that the dividend would be declared out of accumulated profits, therefore it would be legal as far as that point was concerned. There remains only the contract with the bondholders to be considered. The trust deed obligates the company to set aside a certain sinking fund at regular intervals "out of profits." This can mean nothing else than that the sinking fund instalments shall be paid "out of the funds realized from profits." It is a precautionary measure intended to prevent the directors from dissipating the funds by paying dividends before the required contribution to the sinking fund is provided. But it does not prevent the making of contributions to the sinking fund by the use of money that is obtained from sources other than profits. Therefore the company could use the $100,000 idle cash to buy that amount of bonds for the sinking fund, thus putting themselves in the position of having anticipated the requirements of the trust deed by $100,000 plus the difference between that sum and the present value of instalments amounting to $100,000.

It does not seem to need any argument to prove that this anticipation of the instalments which it had been intended should be provided for by future profits would release those profits from the requirements of the trust deed and make them available for dividends. If all the profits were thus distributed in dividends up to $100,000, the situation, other things being equal, would be:

Sinking fund bonds	250,000	Capital stock	500,000
Other assets	950,000	Bonds	400,000
		Accounts payable	125,000
		Surplus, all appropriated	175,000
	1,200,000		1,200,000

No one could object to this disposition of the $100,000 cash. The bondholders would be satisfied because the sinking fund established for their

protection is as large as they have any right to claim that it should be at this date, and the stockholders would naturally not complain at receiving the extra dividend.

But if it is admissible to devote the unexpected cash to the sinking fund and the money derived from subsequent profits to the payment of dividends, the converse must be held to be equally admissible, namely, that the cash can be used at once for the payment of a special dividend of $100,000, and future profits may be depended upon to take care of the sinking fund as the trust deed provides.

The point is that there is nothing sacred about the appropriated surplus. It can be encroached upon, provided there is no danger that such action will in itself endanger the sinking fund. If future profits were not sufficient to provide the required contributions to the sinking fund, the deficit would not have been caused by the use made of the unexpected cash, but would have occurred in any event.

If this reasoning is agreed to, there is another encroachment upon the appropriated surplus that must also be allowed. Suppose that no unexpected cash is obtained, but that in regular course the sinking fund and the appropriated surplus have reached $250,000, and the directors realize that it is useless to carry so large an item in the surplus account where it is unavailable. They therefore declare a stock dividend of fifty per cent., raise the capital stock to $750,000 and completely wipe out the appropriated surplus. Again, no one can object, because no one is harmed.

What, then, is the use of the division of the surplus account between appropriated and free? There is only one reason for it. It explains to the stockholder why he cannot receive cash dividends commensurate with the large surplus appearing on the balance-sheet. That is a financial and not a legal or an accounting inhibition, and only financial considerations must govern the treatment of the subject. If the appropriated surplus is partly or entirely wiped out, the accounting has helped to simplify the explanation of the financial situation.

There is one occasion when some notice must be taken of the appropriation of the proceeds of profits to the sinking fund as an accounting necessity. This occurs when the actual contributions to the sinking fund are less than those required by the trust deed, although the profits have been ample to cover the requirements. This deficit is a liability that affects not only the free surplus, but the active assets as well. It should be included among the active liabilities as a debt due at once. Merely to show appropriated surplus as that much larger than the sinking fund will call attention to the fact, but will not show the amount as a current liability. It may be shown in a foot-note, but that is not at all satisfactory. It can probably be shown best as an addition to the sinking fund, thus:

Sinking fund bonds	140,000	
Unpaid instalment due	10,000	150,000

with an item among the current liabilities of sinking fund instalment due 10,000, the entries to be reversed when the contribution is made.

A strange part of this whole subject is that no attention is paid by accountants to any appropriation of profits other than that involved in the establishment of a sinking fund. If a company without any bonds outstanding has used a very large amount of the funds provided out of profits to build additional plant it would have a large surplus which it would be financially unable to use for dividends. Yet in such circumstances no one seems to think that it is necessary to notify the stockholders by dividing the surplus. Why the stockholders should understand one condition better than they could the other is hard to see. Yet the only difference is that in one case the appropriation of the funds is voluntary and in the other is compulsory. As far as the ability to pay dividends is concerned the situations are identical.

Amortizing Serial Bonds

Editor, Students' Department:

Sir: $1,000,000.00 serial bonds issued to be retired over a period of five years, interest rate 5%. It is desired to retire an amount of principal each year that added to the interest due will equalize the total amount (principal plus interest) over the entire period. In other words, the amount paid each year for both purposes will be neither greater nor less than that paid during any other year.

Will you please inform me as to some simple method of calculation by which these results may be obtained? Yours very truly,

R. S. H.

The $1,000,000 is the present value of an annuity of unknown payments at 5 per cent. Assuming that the reduction of principal is made annually and coincides with the interest dates, the computation would be:

Present value of annuity of $1 at 5% for 5 periods is $4.329477

Then

$1,000,000 ÷ 4.329477 is $230,974.78, the annual payment.

If no table of present values is available and the regular formula is not remembered, the present value of the annuity can easily be calculated by finding the present value of $1 for each successive year, thus

1.000000	÷	1.05	=	.952381
.952381	÷	1.05	=	.907029
.907029	÷	1.05	=	.863838
.863838	÷	1.05	=	.822703
.822703	÷	.105	=	.783527
				4.329478

The proof of this is shown by the following table:

Year	Payment	Interest paid	Bonds paid	Balance
				1,000,000.00
1	230,974.78	50,000.00	180,974.78	819,025.22
2	230,974.78	40,951.26	190,023.52	629,001.70
3	230,974.78	31,450.09	199,524.69	429,477.01
4	230,974.78	21,473.85	209,500.93	219,976.08
5	230,974.78	10,998.80	219,975.98	.10
	1,154,873.90	154,874.00	999,999.90	

The discrepancy is owing, of course, to dropping fractions of one cent.

Practically this theoretical treatment cannot be followed out exactly, because there are no such odd amounts in the bonds to be paid. It would be necessary to raise or lower the annual payments so as to allow of the redemption of an even $1,000 or $500, if bonds are issued for the smaller amount. This would make a slight difference in the interest, but it would not be important.

The theory of this and kindred problems is discussed in *Accountancy of Investment,* by Sprague and Perrine.

Life Insurance Policy as an Asset

Editor, Students' Department:

Sir: In your issue of April, 1918, you answered an inquiry from Mr. Wheeler in reference to the principles involved in carrying an insurance policy as an asset on a balance-sheet. Your reply indicated that the cash surrender value of the policy should be set up on the balance-sheet under current assets, and that the difference between this item and the premiums paid should be charged as an expense.

We have recently noted a balance-sheet wherein the entire amount of the insurance premium for several years has been carried as an asset account and nothing charged to expense. The policies were ordinary life insurance policies made out to the corporation, and they were carried in the balance-sheet under the heading "deferred assets." Kindly give me your opinion with reference to this practice. H. E. C.

There are two objections to carrying as an asset the total of premiums paid on an ordinary life insurance issued on the life of an officer of a corporation.

One is that in that form of policy the insurance feature predominates. The result is that the cash value is very small, and if the insured lives long enough the premiums will amount to more than the face of the policy. At no time is the policy worth what it is carried for, unless it becomes a claim by the death of the insured.

The other objection is that it presupposes the continuance of the policy until the death of the officer, which can by no means be taken for granted.

The officer may resign or be discharged. If this happens, the company must give up the policy, since it no longer has an insurable interest in the officers' life. All that the company can realize on the policy will be its cash surrender value at the end of the year for which it has paid the premium. It is not necessary to surrender the policy to the insurance company, if the officer wishes to continue it for the benefit of his estate and is willing to pay the cash surrender value to have it transferred to him.

Or the company may fail, in which case the receiver must collect the cash surrender value either from the insurance company or from the officer.

If either of these contingencies happens, the overvalued asset would have to be written down. In the meantime, the accounts would be illogical, because they include an asset at a speculative value, and also because they represent the company as insuring an expensive risk without paying anything for it.

The classification of the asset of "life insurance policy" should be as an investment, rather than as a deferred asset, or as a current asset, as we formerly stated.

Errors in Posting and in Trial Balance

Editor, Students' Department:

Sir: If the following questions possess sufficient merit, I would like to see them discussed in The Journal of Accountancy:

1. After closing the books of original entry for the month and posting the entries to the ledger you find you posted a payment to cash purchases instead of accounts payable.
2. How should one proceed to detect an error in a trial balance?
3. What is the advantage of having the cash account in the ledger?

Yours very truly,

New York. S. G.

1. If the posting referred to was that of a single item posted separately, it can be corrected by ruling out the amount in cash purchases account on the ledger with red ink and then making the proper posting to accounts payable.

If the cashbook has columns for cash purchases and accounts payable and the item in question has been entered in the wrong column, the correction must be by journal entry, debiting accounts payable, and crediting cash purchases.

2. There is only one infallible way to detect an error in a trial balance. Divide the ledger into sections: if bound, each section may consist of 50 or 100 pages; if loose-leaf and alphabetical, each letter may be taken as a section. On analysis paper, head columns with the page numbers or letters representing the different sections. From the books of original entry post each item to its proper column. Bringing the results together you will have all the debits and all the credits for each section for the month. From the trial balance at the beginning of the month ascertain the total debit balances of each section, to which add the month's debits for that section. Do the same with the credits. The difference between these debit and credit totals should be the same as between the two sides of the trial balance for that section at the end of the month. In this way all sections in which there are no errors will be eliminated. The sections that do not prove may be carefully checked or may be again blocked into sections of a very few pages each.

3. There is no special advantage in having a cash account on the ledger, except to make the ledger complete in itself.

Stock Dividend—or Bonus

Editor, Students' Department:

Sir: I am employed by a corporation which at the present time is developing an aero-cruiser for commercial air traffic. The company has a capital of $1,000,000, par value $50 a share. Stock is selling for $100.

Here is an outline of what the company proposes to do. Sell enough stock to build and test first machine, which will cost about $400,000. After the test of this machine has proved successful, additional capital will be required to open up a commercial air route to all important cities in this and foreign countries. The increase will possibly be first to $50,000,000 and the par value will be increased from $50 to $100. All stockholders will surrender their certificates after the increased capitalization has been formulated and for every share surrendered will be given twenty-four additional or a total of twenty-five shares, the balance to remain in the

treasury to be sold for additional working capital to finance the company. This then would mean a stock dividend to all stockholders of 2400%. Under the first paragraph I have shown the entries as follows:

Charge subscription account	$100	
Credit unissued stock		$50
Stock premium account		50

Is this method correct? Would the division of stock (provided each stockholder is given an additional twenty-four shares) be considered a profit and be subject to federal income taxes?

The present company is incorporated to develop and test a machine and, after it has proved satisfactory, additional capital will be required to open up a commercial air route, as the original capital of this company is to be used only for a test machine.

Will you kindly give me all the information you can consistently give in regard to the above questions?

Thanking you in advance for this favor, I beg to remain

Yours very truly,

St. Louis, Missouri. L. W. C.

Your entry for the original subscription to the stock is correct, but you are wrong in saying that the giving of 25 shares for one at the re-organization is a stock dividend. It is not a dividend of any kind.

Let us assume that 5,000 shares of the old stock are paid for at $100 each. There would then be a credit of $250,000 to capital stock and an equal credit of $250,000 to stock premium. The experiments are all successful and the company proceeds to issue the new stock to its present stockholders at 25 for 1. It will be necessary to make this entry:

Capital stock, for old shares surrendered	250,000	
Premium on stock, for premium on above	250,000	
?	12,000,000	
Capital stock, new issue		12,500,000

It is understood that 25 shares of new stock with a par of $100 are to be given for one share of old stock with a par of $50 and a premium of $50.

The question is: To what account is the $12,000,000 item to be charged? It is not goodwill, because that is something that is the result of an established and successful business. Nothing is said about any patents, franchises or any other asset of that character. As the matter stands, there is only one name for the account, and that is "discount on stock." There would be a plausible excuse for calling it "bonus to experimental stockholders," on the ground that they stood behind a proposition that had a 1 to 25 chance of succeeding, and were entitled to the reward of their daring. In any event the item is not a profit or a dividend from profits, and would not seem to be taxable as income. However, the internal revenue department may rule otherwise.