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Correspondence

"Some Phases of Capital Stock"

Editor, The Journal of Accountancy:

SIR: I would like to make a few comments through your correspondence section on the discussion in the *Students' Department* of THE JOURNAL OF ACCOUNTANCY for October, 1919, of the writer's articles, *Some Phases of Capital Stock* and *Transactions Between Partner and Firm*, appearing in the May and July, 1919, issues, respectively, of the JOURNAL.

DISCOUNT ON CAPITAL STOCK

The writer freely admits that it is not a particularly vicious accounting practice to eliminate stock discounts by means of charges to accumulated earnings. Further, the balance-sheet is of course ideally a statement of financial position (although it is not at all true even ideally that "it tells nothing whatever of past history except the results") and may not show in a single account the total of earnings not paid as dividends; for surplus may be transferred to various "reserve" accounts or be carried to the capital stock account by either of two methods, (1) the stock dividend, or (2) the elimination of any stock discounts or organization deficits. Still, if discounts were retained (even though shown as deductions from formal capital on the liability side) it might yet be true that the balance-sheet would present a more significant picture to the manager or investor in much the same way as does (so it is sometimes said) the retention of the costs of fixed assets in use in the balance sheet, offset by allowances for accrued depreciation, show the situation more clearly than the presentation of net values. In any case the point is no doubt a minor and not a fundamental matter of balance-sheet construction.

The editor of the *Students' Department,* however, goes a bit too far in trying to find a reason for the writing off of discounts when he states that the perpetuation of stock discounts beyond the time when such items might have been eliminated by charges to undivided profits has a bearing upon the liability of the stockholder at time of liquidation. Would any court decide that a mere bookkeeping procedure, the combination of the discount and surplus accounts, had an influence in determining the liability of a stockholder to the creditors? Although court decisions are sometimes based on very flimsy foundations, I do not believe that any court would so decide. If surplus to exceed the discount were once accumulated this fact of earnings invested in the business could easily be determined and would certainly in no wise be affected by the bookkeeping treatment of discounts. The significant thing in the case cited in the *Students' Department* is evidently the fact that the surplus "was a real one," not that the discount had been charged off. The idea that the bookkeeping treatment of discounts—whichever method is used in no way affecting the

periodic statement of net proprietorship—determines in certain cases the liability of stockholders to creditors is ridiculous. Further, the point in any case has no reference to any but insolvent companies, and it is usually agreed that general statements of accounting procedure are intended to apply to the normal, healthy enterprise.

Transactions Between Partner and Firm

No one, of course, is reluctant to "acknowledge that a man may act in a dual capacity." An individual may act in a dozen capacities, in business as elsewhere. The accountant cannot always afford, however, to proceed as if each capacity were represented by an independent person for accounting purposes. He must sometimes recognize that "all roads lead to Rome."

In the unlimited partnership the law recognizes that for the purpose of satisfying the creditors there is no essential distinction between the assets of the firm and other property of the partners. From the point of view of the creditors, accordingly, the typical partnership balance-sheet is a somewhat nominal statement. The accountant assumes a business entity, although the law does not, and prepares the statements from this standpoint; but the point is still well taken that in certain cases this assumed entity must be ignored and the partner as a partner be identified with the partner as an outsider.

In fact the only case in which the accountant can stick safely to the "dual capacity" proposition is the open corporation. Although the law endows every corporation with an entity apart and distinct from the personnel of its members it has long been recognized by the courts that this entity must often be brushed aside to get at the real facts; and the accountant must sometimes do likewise. A rather extreme illustration will serve to make this point emphatic. In a certain corporation ninety-eight per cent. of the capital stock is held by one individual, the president. In regard to methods of disposing of its profits this company has had a checkered history. For several years profits were turned over to the president as "salary"; for a few years regular dividends were declared and paid; in recent years there have been no dividends but the president has "borrowed" a couple of millions from the business, and accounts receivable have been charged with this amount. Now if the corporation in this case is to be viewed as a distinct entity for accounting purposes, and the president as simply an individual borrowing the corporate funds, it appears that the company's invested capital has not been impaired. The income tax unit, however, would ignore the corporate entity in such a case and view this company as essentially a sole-proprietorship. The charges to accounts receivable covering the president's borrowings would be thrown out of invested capital and treated simply as proprietary drawings. And this is, of course, the common-sense way to handle the case.

Similarly, the salaries of officers in close corporations are bona fide expenses if we adopt the view that these officers as employees are entirely distinct and apart from these officers as proprietors. They are hired by the corporation, it may be urged, just as is any outsider, and their salaries

are therefore expenses. The common-sense view in family corporations is that these officers virtually engage themselves. And here again we find the treasury department taking the attitude that the test as to whether such salaries are expenses or in whole or in part profit distributions is reasonableness. In other words the department refuses to be beguiled by the proposition that the stockholder as an employee is entirely distinct from the stockholder as a proprietor controlling corporate policies. The dual functions are recognized, but not the dual business personalities.

"Common sense is not recognized as a guide by some accountants," as the editor of the *Students' Department* points out, but he has tagged the wrong bunch with this label. The accountant who does not recognize common sense as a guide is the man who meticulously follows the two personalities, the proprietor as an employee or borrower and the proprietor as an owner, and insists on maintaining this differentiation in all cases, regardless of the absurdities this practice may lead to in the case of the partnership and the close corporation. Statements of financial operation and condition prepared according to this view will in many cases certainly not be accepted by the courts or the treasury department.

The editor of the *Students' Department* makes one criticism which is evidently due to an oversight. In speaking of the case where B does not pay interest on his drawings but authorizes a charge to his capital account he quotes from the article in question as follows:

" 'The concurrent credit in such a case is usually to the interest revenue account, and if this procedure is followed the entries giving effect to this agreement would be:

B, Capital	$600	
Interest		$600

" 'The credit to interest is ostensibly a revenue item, but a careful examination of the case discloses the fact that no revenue whatever was involved and that the essence of this transaction is simply an adjustment between the two partners. This can perhaps be best shown by an examination of hypothetical balance-sheets *as affected by this transaction alone.*' " The first balance-sheet is then given and the quotation continues,

" '*Ignoring all other possible transactions,* and assuming that A and B share income in proportion to respective investments, the item of interest revenue recognized in the above entries might now be divided and credited to the partners' capital accounts.' "

Here follow the entries and the succeeding balance-sheet, and then the conclusion,

" 'A comparison of the two balance-sheets shows very clearly that no revenue whatever has been realized since asset and equity totals remain unchanged . . . .' "

In criticism of this demonstration the editor states that "it cannot be too strongly emphasized that a comparison of two balance-sheets does not show anything whatever in regard to intermediate profit or loss," and goes on to show this by bringing in additional transactions and assuming the

profits resulting therefrom withdrawn. In view of the italicized statements above (the italics were not, of course, in the original article), which the editor himself quotes, it is evident that this criticism is entirely undeserved. The demonstration given was sound. It is certainly true if balance-sheets were struck immediately before and after a single transaction containing an element of net revenue that the totals of the second balance-sheet would be larger than those of the first by the amount of such net revenue.

Yours truly,

W. A. PATON.