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# Accounting Questions

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## *ELIMINATION OF NOTES FROM BALANCE-SHEET*

**Question:** In 1934 a corporation had a paid-in surplus of $2,000,000 and an operating deficit of $1,000,000. The company began to show profits in 1934 and, in order to enable the company legally to pay dividends under the laws of . . . (the state in which the company is incorporated), the board of directors passed a resolution to wipe out the operating deficit by charging the amount against the paid-in surplus.

The necessary papers were filed with the Secretary of State, and in the opinion of the company's attorneys, the deficit was thereby wiped out and the company thereafter capable of paying dividends.

Each year since the above change took place in the capital accounts, the surplus accounts have been described as follows on the balance-sheet:

Paid-in surplus (less operating deficit at December 31, 1934)
Surplus earned since December 31, 1934.

In addition, a note has been placed at the foot of the surplus accounts for the year, reading as follows:

> "The paid-in surplus shown is after deducting the operating deficit at December 31, 1934, in accordance with a resolution of the board of directors."

The question on which we would like to have an opinion is whether we can with propriety eliminate in whole or in part the unusual description of the paid-in and earned-surplus accounts of this company, particularly the words "less operating deficit at December 31, 1934," added to the term "paid-in surplus" and the above-mentioned note which now appears at the foot of the surplus account for the period.

**Answer No. 1:** In our opinion, the words "less operating deficit at December 31, 1934" could be eliminated with propriety.

**Answer No. 2:** As I understand the hypothetical situation set forth by the inquiry, it is that as at December 31, 1934, an . . . corporation, by appropriate action in every respect complying with the laws of that state, wiped out its operating deficit by a charge against its paid-in surplus and thereafter its balance-sheets have shown two figures to represent its surplus, namely:

Paid-in surplus (less operating deficit at December 31, 1934)
Surplus earned since December 31, 1934

and have carried a footnote reading as follows:

> "The paid-in surplus shown is after deducting the operating deficit at December 31, 1934, in accordance with a resolution of the board of directors."

The inquiry is as to whether the "unusual" description of the paid-in and earned-surplus accounts and the quoted footnote may with propriety be eliminated from the balance-sheet.

Answering the second question first, I would express the opinion that the footnote is repetitious and unnecessary. As to the first question, it is my opinion that failure to disclose the fact that an accumulated operating deficit had been applied in reduction of the paid-in surplus and that the earned surplus has arisen only since December 31, 1934, and has not absorbed a prior operating deficit would constitute an "omission (from the balance-sheet) of such a fact as would amount to an essential misstatement or a failure to put prospective investors on notice in respect of an essential or material fact not specifically shown in the balance-sheet itself" (Rule 2 of the rules of professional conduct, American Institute of Accountants) and an omission "to state any material fact required to be stated therein or necessary to make the statements therein not misleading" (securities act of 1933, sec. 8, paragraph D).

**Answer No. 3:** It has been quite a general practice in the past to charge operating deficits against capital surplus and make no reference to such accounts in future years. However, it is believed that the present trend toward the preparation of more informative statements has reached a point where the silent treatment is no longer held proper.

The phraseology used in your letter, namely,

"Paid-in surplus (less operating deficit at December 31, 1934)"
"Surplus earned since December 31, 1934"

is very appropriate and should be continued.

It is believed that accountants should insist on such explanatory notes being shown in statements prepared by them.

It is not believed that the notation:

"The paid-in surplus shown is after deducting the operating deficit at December 31, 1934, in accordance with a resolution of the board of directors"

is needed as a continuing footnote although its appearance on the statements for the year when the charge was made is very desirable.

## *WRITE-OFF OF APPRECIATION*

**Question:** The X Corporation issued capital stock against the appreciation surplus which resulted from a board-of-directors appraisal of the buildings. Is there any sound principle which justifies the treatment of the write-off of the appreciation in any other manner than as expense, similar to depreciation expense on the cost of the buildings?

**Answer No. 1:** If appraisal surplus is extinguished by the issuance of capital stock, then depreciation on appreciation must be charged to expense (although it will not be deductible for tax purposes), as well as depreciation on cost. In the recent case of a new client where we found this situation, we recommended the reduction of capital stock in an amount equivalent to the remaining appreciation, in order to reduce charges to expense and to avoid keeping two sets of depreciation schedules, one for book purposes and one for tax purposes.

**Answer No. 2:** It appears that the board of directors of the X Corporation revalued the buildings and that capital stock was issued against the resultant increase. Inquiry is made as to whether there is "any sound principle which justifies the treatment of the write-off of the appreciation in any other manner than as expense, similar to depreciation expense on the cost of the building."

Following the appraisal, the basis of the charge for depreciation of buildings is the increased value then determined, and the appraisal surplus having been capitalized, unless the total is recouped through operations by periodic charges for depreciation during the effective life of the buildings, the operating results are not correctly stated. Any other treatment is, we believe, opposed to sound principle.

**Answer No. 3:** The premises recited consist of two actions, namely, an appraisal of buildings by the directors, resulting in a credit to a capital-surplus account, such as surplus from appreciation of property; secondly, the permanent capitalization of that capital surplus by the issue of capital stock.

Had only the first act taken place, there would have been two alternative methods of charging the depreciation: one, charging depreciation on cost against income, and depreciation on the appreciation against surplus from appreciation, which would seem to give a basis for proper cost of product, but would not maintain the capital represented in the appreciation intact; the other, charging income with depreciation on the reappraised value, which would thereby maintain the capital in the appreciated value of buildings intact out of income.

Inasmuch as capital stock has been issued, in our opinion a failure to provide for depreciation on the book value of buildings would result in a loss of value of the capital issued. If all net income in such case were thereupon to be paid out in dividends, part of such dividends would be out of capital. It is our opinion, therefore, that in the circumstances recited there is no sound principle which justifies the treatment of the write-off of the appreciated value in any other manner than as expense.

If the directors of the X Corporation deem it desirable, it might be possible to arrange for a reduction of capital stock to eliminate an amount of par value, or of stated value of stock without par value, equivalent to that issued for appreciation in property value, restoring the amount to capital surplus and making such surplus available for cancellation of the property appreciation either by proration over the life of the property or by writing off the appreciation in total, if the directors no longer consider the book values justified.