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Problems in accounting for owners' equity

PROBLEMS IN ACCOUNTING FOR OWNERS' EQUITY

by

Lillian Bell, A. B.

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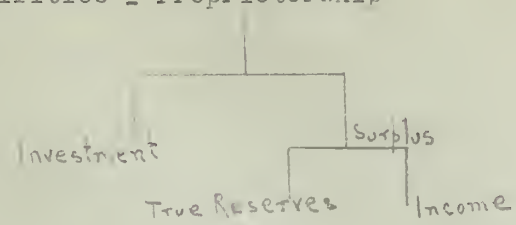
Assets, Liabilities, and Capital are the three great captions under which all the items of the science of accounting are classified. These are formulated into the simple algebraic equation: Assets = Liabilities + Capital, and form the basis of accounting theory. This equation is known as the Balance Sheet Equation. Under the Assets are grouped the properties owned and under Liabilities and Capital the claimants who own or have an equity in the assets. Stated in another way, the Assets are the funds, and Liabilities and Capital, the source of these funds. Each term of the equation is a sum of its various parts.

Each term of the algebraic equation may be expressed in relation to the other; and if the algebraic rule of subtraction is applied, the equation can also be stated as Capital = Assets - Liabilities. Capital, then, is the difference between the Assets and Liabilities or it is a Remainder of the Assets after the Liabilities have been deducted. This residuum of the Assets is called Net Assets or Net Worth.

The study of the subject matter grouped under the "Capital" caption, falls into two distinct divisions: One we shall call "Proprietorship" or Net Worth and the other "Ownership" or Owners' Equity.

Proprietorship or Net Worth embraces problems of a general nature, which may be graphically expressed thus:

Assets - Liabilities = Proprietorship



Ownership or Owners' Equity deals with problems of a more specific nature, which arise from the particular organization of proprietorship; the most common of which are a single proprietorship, a partnership and a corporation. There are also various combinations of corporation and partnership organizations, the best known of which is the so-called "Massachusetts Trust".

As illustrated above, Proprietorship or Net Worth, is the difference between Assets and Liabilities. It is the properties remaining after the creditors' and other preferred claims have been satisfied. The importance, therefore, of correctly valuing the assets and liabilities cannot be minimized since upon this depends the accuracy of Net Worth. It must be remembered that the theory of accounting is based upon an equation and that one value is balanced against another; and, as it is fundamentally true of all equations, any change in one side will work a like change in the other.

Furthermore, Proprietorship or Net Worth originates from two distinct sources: that is, the original investment of the owner or owners in the assets, and the increases or decreases

in the net assets resulting from operations. If the result is an increase, it is known as profit; and if it is a decrease, there is a loss. If the assets are overstated, the net worth is inflated; if they are understated, secret reserves are formed.

The significance of the above facts becomes more apparent as the particular type of business organization becomes more complex. In a single proprietorship, the owner being one individual, the unfairness and injustice arising from a misstatement of net worth is not so great as in a partnership or corporation, since, in any event, the entire net assets belong to him. When the net worth belongs to two or more individuals great wrongs may result, especially if the owners are constantly changing.

The changing of owners sometimes give rise to a new asset known as good will. Difficult and numerous are the problems and methods of evaluing assets and liabilities, but the value of good will is largely an estimate even under most scientific methods. Good will arises when there is superior earning power. It may be real or it may be anticipated; at any rate, it is the capitalization of the estimated surplus profits for a number of years. It may be bought and a definite sum paid for it; but the amount paid may or may not be the correct value of the asset. The value depends upon the amount of future income and the continuance of the same.

The purpose of this paper is to study certain facts connected with "Capital" and its various components: and to review the problems in accounting which they present. The subject matter is not new, but the information regarding it is so scattered that a student desirous of obtaining it is forced to wade through numerous volumes and "thumb" countless indexes. This paper will be an attempt to collect the necessary data and present it in a comprehensive summary. It will not be an exhaustive treatise of the subject but rather a brief presentation arrived at from the point of view of the student who is attempting to learn.

To repeat, the general problems in accounting for proprietorship or net worth are closely interrelated with those of the assets and liabilities and will receive little attention here. The subject matter of this paper is accounting for owners' equity under the various types of business ownership.

Under a single proprietorship, no particular accounting problems in owners' equity arise since he owns the residuum of the assets, and all the accounting problems are of a general nature. In a partnership, however, where the net assets may be owned by two or more individuals, problems in accounting for owners' equity peculiar to this form of business organization are presented.

The creation of a partnership rests upon a contract,

written or oral, between two or more individuals to carry on a business for profit. This document is called the articles of co-partnership and forms the basis for directing the entire business relation of the partners. Where the articles fail to mention the agreement concerning a certain matter, common law rules.

In a partnership there is a double ownership, one in the assets and the other in the profits. Ownership in the assets consists of the original investment and any additions or deductions from it, while proprietorship in the profits is common ownership of each portion as it is earned. Ownership in one is independent of that in the other.

The problems in accounting for owners' equity in a partnership may be divided into the following problems:

1. Those concerning the formation of the partnership.
2. " " " sharing of profits or losses among the partners.
3. Those concerning the liquidation of the partnership.

When a new partnership is formed, the problem in accounting is the correct crediting of the capital accounts of each partner. The assets contributed by each partner may be of any nature; cash, property, tangible or intangible. The value set upon them may be any amount agreed upon by the partners. The entire asset can be contributed by one partner or by all in any proportion decided upon. It is important in

recording these assets to credit each partner's account with the amount which he actually contributes and to debit the proper asset accounts for the properties so furnished. The assets become the property of the partnership and the net worth of the partnership is presented on the books by the sum of the capital accounts of all the partners.

In this respect it must be mentioned that any asset to which a partner does not relinquish the equity, is an asset of the partnership but is not to be credited to the capital account of the partner who permits the use of such property. A separate account should be credited and properly labeled so. However, "whether formal conveyance of the legal title is made or not, if the property is turned over to the firm as a contribution of an individual partner, it will be considered to belong to the firm and will be treated as an asset in winding up".[1]

A new partnership results whenever a new partner is admitted to the business. His contribution to the partnership may result in an increase in the total net assets of the partnership or not. If there is no increase in the net worth, the admission is known as "entering a partnership"; if there is an increase, it is known as "making an investment".

In entering a partnership, the new partner purchases a certain portion of the net worth of the existing business for which he pays a sum agreed upon. This amount thus paid may

1. Perrin & Babb: Commercial Cases Vol. II Pg. 321

equal exactly the portion of net assets purchased; however, it may be more and it may be less.

The property which the new partner contributes does not become the property of the new partnership; it belongs to the old members of the business. In other words, the former owner or owners sell a certain ratio of his or their ownership to the incoming partner. It is of the utmost importance that these facts be correctly recorded when the new partner enters the partnership. The capital account of each partner should reflect exactly his ratio of ownership of the total new assets to which an agreement has been made at the time when the new partnership was formed.

If the former business had been a single proprietorship, the owner receives the property contributed by the new partner but it does not add to the net assets of the business; they remain the same. The only difference now is that instead of one capital account, there are two, the sum of which equals the total net worth. If the preceding enterprise had been a partnership, one of the partners (with the agreement of the other) may have sold his interest in the assets or both may have given up certain portions of their respective ownership to make up the ratio purchased by the new partner. It does not matter what their agreement has been; the accounting problem is to represent this agreement correctly in the accounts.

The best method is to make an entry debiting the assets

for the properties contributed by the new partner and to credit his capital account if he paid exactly the book value of his portion of ownership. Then make entries correcting the accounts of the former members by debiting their capital accounts and crediting the appropriate assets for the amount of ownership relinquished and for which they are being reimbursed from the funds contributed by the new partner.

The new partner may have paid more or he may have paid less than the actual ratio of net assets purchased. This condition brings up the problem of the proper evaluing of the assets to reflect the newly appraised net worth. If he paid more, there is a new asset, good will, resulting; if he paid less, it means that the assets are not worth their book value. This transaction gives rise to profit or loss from reorganization and the former owners share in this profit or loss according to their old profit and loss ratio.

If the assets are written down to their newly appraised value, the capital accounts of the former owners are debited, according to their profit or loss sharing ratio, with the amount of loss resulting from the write down due to the admission of the new partner. The net worth of the partnership is reduced by the amount of the write down. The new partner buys an interest in the newly revaluated business and the amount he pays is credited to his capital account. The debit, however, is to the various partners' accounts, depending upon

the amount of ownership the respective partners decided to relinquish to make up the ratio purchased by the new partner. It may be desired, however, that the net worth should remain the same as before the write down of the assets. In such a case, the old partners must make up the difference of that loss according to their profit or loss sharing ratio. Thus, the partners lose by the transaction but not the partnership.

If the new partner pays more than the book value of the net asset he purchases, the capital accounts of the old partners are credited according to their profit or loss ratio. The greater amount paid may have been due to the write up of the assets or to a payment for good will. If the assets were written up the debit for the excess amount paid over book value of net assets is to be recorded in the various assets which were written up. If the payment is for good will, this new asset may be set up on the books or not depending upon the agreement of purchase. The setting up of good will or the increasing of the value of the assets results in an increase in the net worth. If it is not desired to increase the net worth, the old partners withdraw the increase in accordance to their profit and loss sharing ratio.

The nature of good will raises a new accounting problem. As defined before, good will is the capitalization of excess earnings. Although the past earnings of a business may serve as a basis for co puting good will, the fact remains that

good will is really a capitalization of estimated future earnings. If set up on the books of a business, the future earnings for a period will have been capitalized.

The accounting problem is to make entries which properly record the agreement made by the partners. If good will is set up on the books and credited to the former partners' capital accounts, it indicates that the new partner reimbursed the old partners for a portion of their future earnings. If it is set up and credited to the new partner, the old partners are selling a portion of their future earnings. If it is set up and credited to all the partners' capital accounts: that is, old and new, all the partners are capitalizing a part of their future income. If it is not set up on the books, and the old partners share in this additional amount, they receive a bonus from the sale of part of their interest. The new partner, however, pays a greater amount in anticipation of future profits. For a time, the income which he receives for the partnership will be a return of capital.

The admission of a new partner may change the total net worth as well as the particular capital accounts of the partners. Such a transaction in the admission of a partner is known as <u>making in investment</u>.

Whatever the ratio of ownership in the assets of the new business the incoming partner buys, the properties contributed by him will become the assets of the new partnership and

will increase the total net worth.

The important fact to remember here is that the total Net Worth has changed and the total net assets of the former partners are only a part of the increased Net Worth of the new business. Thus, if the new partner invests a third interest in the new partnership, the total net assets of the former partners are now only two thirds of the whole new capitalization. This seems a very simple fact; however, innumerable errors, which cause grave misunderstandings, occur because this plain and obvious fact is not remembered.

To place this transaction on the books, the properties contributed by the incoming partner should be debited to the proper asset accounts; the capital account of the new partner should be credited with the amount invested. This entry is made when the new partner pays the exact amount of his portion of capital ownership in the new partnership.

If the new partner invested more than the value of his portion of ownership, we have again the problem write up of assets or good will. How good will should be handled depends upon the partnership agreement. If the new member paid less, there is negative good will.

The resulting profit or loss from this transaction should be credited to the old partners' capital accounts according to their profit or loss sharing ratio. This entry will change the capital accounts of the former partners. Even if the a-

mount of their capital accounts is not changed, in the admission of a partner by making of an investment, the ratio of ownership is changed, since their former fractional ownership is different in comparison with the newly increased net worth.

Whether the original ratio of interest in the assets should be maintained throughout the existence of the partnership depends upon the articles of copartnership. Periodic adjustments of the capital accounts will produce new balances and will change the original ratio of interest in the assets. Unless drawings from or additions to the capital accounts are made at such times, the ratio among the partners and the net worth will change.

The ratio of ownership in the assets, however, does not necessarily have any influence or bearing whatsoever on the ratio of ownership in the profits or losses. These two forms of ownership are independent of each other. The sharing in profits carries with it the corollary of sharing in losses also.

While there is no common law rule as to the ratio of interest in the assets, in case of an omission of this point in the articles of copartnership, the rule as regards profit and loss is that they are to be shared equally by the partners.

An agreement as to the sharing of profits may be made in any way the partners desire. The nature of the enterprise and the contributions of the several partners should be the deciding factor. The ratio may be purely arbitrary depending upon

the respective bargaining power of the partners or perhaps just lack of definite information. Such a decision, as all arbitrary means, is usually a matter of expediency rather than thought and calculation. In certain cases where it is difficult to ascertain a definite method of evaluing the respective contributions of the several partners, such a method may be not only expedient but the best possible means.

However, usually a partnership is formed where each of the several members has certain qualifications which the others have not. It is well in fixing the profit and loss ratio to bear this in mind.

Another basis for distribution of profits and losses which seems rather out of accord with equity is to use the same ratio as that of capital. Or course, here, as in all other matters of partnership, the agreement between the partners rules. It is not the accountant's job to look beyond that. However, as an equitable distribution of profit or loss, it is not above criticism. Of course, it may be possible that each contributing partner has the same ratio of skill or prestige as the amount of capital he invests. Such a condition, however, is very rare. In a partnership, it is not usual for each partner to contribute either capital, skill, time, prestige, good will or other properties or personal qualities in the same ratio as that of every other. It is humanly impossible.

To equalize the differences among the partners, however, it is very advisable to distribute to each partner a part of the profits on the basis of his particular contribution. Thus, if he contributes more capital than the other, interest should be paid him; if he gives special skill or time, he should receive a salary; if he draws a special clientelle, a bonus on the business of the clientelle would take care of this inequality. The remaining profit, which arises from the combined energies of all the partners, should be distributed equally among them. This seems a very just and proper means to adopt for distribution of profit and loss. However, it, too, has its drawbacks. To measure human qualities for compensating purposes is a difficult task and cannot be properly set aside by a peremptory statement. Still, there is much in favor of the above methods.

It must be borne in mind that all distributions, whether they be in the form of drawings, salary, interest, bonus, are, so to speak, dividends and primary divisions of earned profit unless there is an agreement to the contrary. They may be considered as expenses of the business for the purpose of comparison with other concerns in the same line under different forms of organization, but as far as the partners are concerned, they are distributions of profit.

For the purpose of convenience, the partners' capital accounts may be divided into different accounts such as drawings, interest, salary or bonus; however, in the final anal-

ysis they must all be combined into one to ascertain each partner's equity in the new net assets.

When the above principles regarding the showing of profit and loss are understood, the accounting problems in this respect are simple. All that is required is, that after the profit or loss for a period has been found, to close such a profit or loss, according to the articles of copartnership agreement as regards the sharing of profit or loss, into the capital accounts of the several partners.

No difficulty arises when profits are to be distributed arbitrarily. The ratio is given and when the profit or loss for the period is ascertained, there is only the mathematical calculations to be worked out in order to credit or debit properly the capital accounts of the partners. However, when the capital accounts of the partners are to serve as bases for the distribution of the profits or losses, then it must be clearly defined whether the original ratio of capital investment, or the capital accounts at the beginning or the end of the final period, or the average capital maintained is to be used as a basis. The usual procedure is to use the same ratio as that of the original investment.

The same problem arises when interest is to be paid on capital investment. Of course, interest paid to partners on capital retained in the business carries with it the assumption of a charge of interest for drawings. The most equita-

ble basis, therefore, is to pay interest on the average capital. However, that average must be properly computed.

It is not to be construed that the above are the only means of sharing in the profits or losses of a partnership. The ways and means adopted may be as varied as the partners desire. The profit of the sales of the individual partner may be credited to that partner; losses sustained through bad debts on such accounts may be charged to the account of that partner instead of to the partnership. Several of the partners may agree that one of them should be paid an interest on his capital, or a salary or a bonus, even if there be no profits. In such a case, the partners so agreeing bear the loss according to their profit and loss ratio. Here it must be remembered that the partner who is thus favored bears in the loss created his proportionate share of such a loss.

Furthermore, the sharing in the profits or losses does not mean that those profits or losses should arise through operation only. It pertains to all profits or losses, whether they arise from operation, the sale of capital assets, the admission of a new partner, or the liquidation of the business.

If no definite mention is made in the agreement, no partner is entitled to salary for services, to interest on capital, or to bonus on sales. The only means of sharing in profit and loss is then on an equal basis.

Dissolution of partnership occurs when a new partner is

admitted, when an old one retires, when the business is sold, liquidated, or its form of organization changed. This dissolution may be by agreement according to the articles of copartnership or it may be involuntary due to a disagreement among parthers; the insanity, continued illness, death or bankruptcy of one of the partners; the failure of the enterprise to make profits, or bankruptcy of the partnership.

When a new partner is admitted, the old partnership is dissolved. As explained before, if the new partner buys an interest, any one or all of the old partners sell portions of their ownership in the net assets to make up the ratio purchased by the new partner; if the new partner makes an investment, the old partners contribute the old business as their investment in the new partnership. In either case, legally, the old partnership no longer exists, although to all appearances it remains unchanged. The adjustments among the old partners' capital accounts are made as explained before. In case of a profit or loss, resulting from such a reorganization, the old partners share in it according to the old partnership ratio of sharing in profits. These results are recorded in the old partners' capital accounts and the books are adjusted to reflect the new arrangement of ownership in the assets of the respective partners in the new partnership. Through these adjustments the old partners may have gained, lost, or their status of ownership may have remained unchanged.

An old partnership is also dissolved when an old partner retires. The problems and adjustments are very similar to those when a new partner is admitted. Here again the respective ownership of the individual partners in the net assets is changed.

It is quite clear that it is impossible to have the assets correctly evaluated at all times. Furthermore, the value of assets of a going concern and that of a liquidating one is different. Thus, when an old partner retires, it is well to revaluate the assets. If they are overvalued, a burden will fall upon the remaining partners; if they are undervalued, the outgoing partner is not receiving all he is entitled to. The profit arising should be credited and the loss debited to the partners' capital accounts according to their profit or loss sharing ratio. As regards good will at the retirement of a partner, if the articles of copartnership provide for it, there will be a stipulation as to its computation. It must be remembered that good will is the capitalization of future earnings. The retiring partner, if he stayed in business, would receive these future profits. He may at retirement be willing to receive an allowance. It is, therefore, quite proper to set up good will and credit the retiring partner's capital account with the amount. Whether at this time the entire good will of the partnership should be set up and all of the partners' accounts credited according to their profit and loss

ratio is rather a moot question. Although the old partnership is dissolved and it would thus seem rather proper to credit good will to the old partners' accounts, yet, after analyzing the matter, it will be seen that, as far as the remaining partners are concerned, they are only capitalizing the future earnings in a business in which they will continue as members and draw future earnings. It is never correct to anticipate profits before they are earned and record them. This is just what would happen as far as the old partners are concerned. It is more conservative, then, to set up only the good will accruing to the retiring partner.

Then, too, there is some controversy as to the ratio in which the profit arising from good will should be shared if that ratio is changed during the life of the partnership. There is no real ground for using any other but the existing profit and loss ratio, since it is a settled question that profit and loss should be shared in the existing ratio at the time when profit or loss accrues.

After these adjustments are made, the outgoing partner's account should be set up as a liability if it is not cleared by actual payment of cash. The net assets thus remaining are the net worth of the new partnership to be divided among the remaining partners in the old ratio of ownership in assets or any new ratio they may decide upon. The profit and loss ratio may also be readjusted by the new partners if they so desire.

At any rate, whether the retirement of the partner resulted in the formation of a new partnership or not, the old one was dissolved by this act.

A partnership is dissolved when the business is sold or liquidated; but until each one of the assets is realized and every liability paid, the partnership exists. The old relation among the partners remains the same; whatever loss or gain is sustained through such a transaction is shared by them in the existing profit and loss ratio. When the business is finally liquidated and the resulting profit or loss recorded in the respective capital accounts, then the net assets are divided among the partners according to their capital accounts. Furthermore, if during liquidation one or more of the capital accounts of the various partners is exhausted through charges of losses, then the remaining partners bear the loss according to their profit or loss ratio. Here, however, it must be remembered that the base has changed and thus the mathematical profit or loss ratio among these remaining partners is different from that which existed at the time when all the partners shared.

It may be possible that payment to the various partners be made only after the business is completely liquidated, the assets realized, and enough cash on hand to pay all the partners their interests completely. However, there may be cases where liquidation takes a long time and it is advisable to

make partial payments on partial realization. Following the principle stated above, that not until the business is completely liquidated are the partners to be paid according to their adjusted capital accounts, when partial payments are made, they are distributed according to the capital accounts only after the remaining unliquidated balance, which is considered as a total possible loss, is apportioned according to the profit and loss ratio among the partners. The charging of the possible loss to the various accounts is only for the purpose of obtaining the amount to be paid to each partner during the partial payments. It need not appear on the books since it is only a calculating entry; it may be carried on the working sheets only.

The actual payment, however, should be debited to the capital accounts of the several partners to obtain the new capital balances of the respective partners; the total of which equals the remaining unliquidated assets. The same method should be used during every partial payment so as to avoid paying one partner an amount which he would later have to return. Such payments are known as installment payments.

An old partnership is dissolved when the partners decide to incorporate. The identical problems present themselves here as those stated above. The assets must be revaluated and and the question of good will decided. Thus, in so far as the partners' accounts are concerned, the same adjustments should

be made as in the sale or liquidation of the business. However, instead of receiving cash, the partners receive the certificate of ownership in the corporation called "stock". These are divided according to the existing capital ratio after all adjustments of profit and loss from this transaction have been recorded.

To sum up, in the formation of a partnership it is important to know whether the new partner is buying an interest or making an investment. In buying an interest, it must be remembered that the new assets belong to the old members and must be distributed among them according to their agreement. In making an investment, it is important to compute correctly the value of the ratio in the new partnership. It is purely a mathematical computation; the total net worth of the former business is now a fraction of the new capitalization. If more than the book value is paid, then positive good will arises; if less than the book value is received, negative good will results. Whether to set it up on the books depends upon the intention of the partners. Bearing in mind the peculiar nature of good will as an asset, the resulting profits or losses may be recorded in the newly incoming partner's account, in the old partners' accounts, or in the accounts of all the partners, depending upon the articles of copartnership. However, if it is distributed among the old members, the ratio of sharing profits or losses in the old partnership rules as to the a-

mount to be credited or debited to each partner's capital account.

Whether the original investment is to remain intact, or whether additions to or reductions from it are to be made depends upon the agreement of the partners. If there is any interest on the capital investment, then there should be a charge for any drawings against capital.

As to the various ways of sharing the profits or losses resulting either from sale of assets, current earnings or liquidation, the ratio of distribution depends upon the agreement among the partners. The important fact to remember is that the accruing profit at the time should be credited and the loss debited to the individual partners' capital accounts in the profit or loss ratio then existing. Whether the earnings are to be retained in the business or withdrawn depend upon the contract between the partners. Any current drawings, whether they be in the form of salary or just drawings, are considered as withdrawals of profit.

In the liquidation of a business, it is imperative first to adjust the respective capital accounts of the various partners according to their profit and loss sharing ratio. Then any payments should be made in accordance with the corrected capital accounts of the partners in such a manner as not to give one partner any amount which he would later be forced to return or owe to any other partner.

As stated before, ownership in a partnership consists of ownership in the assets and ownership in each portion of profit as it is earned. Besides, there is no distinct separation between the partners and the partnership. A firm is not a separate entity in any way different from the various members who compose it; it is for most legal purposes "an aggregate of individuals who are personally responsible for its obligations".[1] Thus, though loans made by partners to the firm may be set up as separate accounts, they are a division of "Capital". Even though they constitute preferred claims as to payments made to partners; as far as third parties are concerned, however, the net assets of a firm are the assets minus liabilities exclusive of loans by partners. These are not considered as liabilities but as additional investments with preferred claims in case of liquidation.

Furthermore, the rule of "set off", which is a custom permitting the access to a loan account of a partner to make up a debit balance in the capital account of a partner having a loan, facilitates the tendency toward combining the loan account with that of the capital account of the respective partner in case of liquidation. Although any payments, thereon, will be considered payments on the loan until that is exhausted, and then the balance will be applied against the capital account, there is really no difference as far as the individual partner is concerned, whether it be the liquidation of the

1. Perrin & Babb: Commercial Cases Vol. II Pg. 269

loan or the return of capital, since there is no further recourse. Furthermore, if the lack in a capital account is not completely set off by a loan account, the partner is personally liable for that deficiency with any other property he possesses outside the business.

Also, because of the complete entity of a partner with the partnership, personal creditors of a partner may, under the law of marshalling, have access to his capital ownership in the partnership if he has no personal properties to satisfy a personal claim against him. Such a condition may cause the possible dissolution of the partnership if the said partner were bankrupt. Although such a possible unforseen liability cannot be set up on the books of the partnership, yet, if the amount is large, mention should be made of the fact on a balance sheet.

All possible financial activities which may have a bearing on owners' equity in a partnership center about the partners' capital accounts and the only accounting problems in owners' equity peculiar to a partnership dissolve themselves into those described above.

Quite a different set of accounting problems in owners' equity is presented under the corporate form of business organization. These problems arise from the peculiar legal origin and customary practice of a corporation.

"A corporation is an association of persons, organized

under the authority of the state, by whose sanction it becomes a legal entity, separate and distinct from the members who compose it."[1] There are various forms of corporations; the only one that interests us is the business corporation or a corporation organized for the purpose of conducting a business in order to get a profit.

Corporate ownership is evidenced by shares of stock. Each share represents a specified aliquot part of the total. If a value in terms of dollars and cents is set upon it, it is known as stock of par value. Almost all states, however, permit the issue of stock without a definite dollar value and such stock is spoken of as no-par value stock. The state may require a minimum value on such stock below which it cannot be sold, or the corporators may designate a value at which it may be sold; however, such stock may be sold for any value it can fetch. The price set upon such stock is called the stated value.

The ownership of shares of stock is acquired by contract with the corporation arising either from subscription, before or after incorporation, from purchase, or transfer of shares of stock from one owner to another. When a transfer of stock is made, it must be recognized by the corporation before its owners can exercise the rights and privileges coincident with ownership.

The ownership of shares of stock is evidence of ownership

1. Perrin & Babb: Commercial Law Cases Vol. II Page 435

in the corporation. The owners of such stock are known as stockholders. Each share of stock carries with it the three rights of ownership: namely; the right to have a voice in the affairs of the business, the right to profits, and the right to the assets in case of liquidation.

The right to participation in the affairs of the business by stockholders lies in voting for directors who conduct the affairs of the business. The sanction of stockholders is also required in decisions which would materially alter the original status of incorporation. Some of these decisions require only a majority vote, others an unamimous vote; however, the statute requirements in each case rule. Aside from these actions which require stockholders' approval, the management of the business is in the hands of the directors selected.

The right to profits of a corporation is dependent upon the declaration of dividends by directors in proportion to the ownership of shares. There is no direct or proprietary ownership of profits as they are earned.

The right to the assets rests in the proportionate sharing in the remaining assets, after creditors and other preferred claimants have been satisfied, among the stockholders in accordance with their stock ownership.

The net worth of a corporation is composed of capital stock and surplus. Surplus is the excess of net worth after the deduction of capital stock. If the balance is negative or

less than capital stock, then the remainder is called a deficit.

The two most common classes of stock are common and preferred. When all the stock is on an absolute equality, it is known as common stock. A corporation may have several kinds of common stock.

Since, however, the acquisition of stock is a contract between the corporation and its stockholders, it may take any form upon which they agree. Thus, some shares, by agreement, have or lack certain rights. These rights may differ as to voting power, sharing in profits, or return of assets in case of liquidation. Such agreements must not be in conflict with the powers given by the state or the original agreement among the stockholders without their acquiescence.

The shares which carry these special privileges or limitations are called preferred stock. The possible preference agreements are many, and thus one company may have several different kinds or classes of preferred stock depending upon the different privileges or limitations attached to each.

Usually, the preference in such stock lies in the fact that it is entitled to receive a stated rate of dividends before any is declared to other stock. However, whether stock is preferred or not, its right to dividends still depends upon declaration by the directors. Furthermore, such stock may carry a clause entitling it, so to speak, to "back dividends"

in case it had been omitted at a previous period. This privilege is known as cumulative. Then, too, it may have the additional advantage of sharing in remaining surplus with the other stock above its stated rate, after a dividend equivalent to the one received by it has been also declared on the other shares of stock. Such a right is known as participating.

Preference to the assets in case of dissolution is also given to certain stock. The agreement may stipulate that the holders of such stock should receive their share of capital stock before any liquidating dividends are given to the other stock. In case of par value stock, it is, of course, the face value of the certificate of stock; as regards no par value, it necessitates the designation of an amount to be paid on such occasions. Furthermore, this advantage may even accrue to any preferred dividends that had not been paid.

As to voting power, some stock may by agreement give up that right, which of course means the relinquishment of any directing of the affairs of the business. Stock having no voting rights is known as non-voting stock.

Thus, owners' equity in a corporation is divided among various stockholders in certain proportions depending upon the number and kind of shares owned. This total, as in any other form of business organizations, is the difference between the assets and liabilities. The value assigned to the various shares, in accordance with the proportionate amount

accruing to each share as regards its fractional part compared with the total net worth presented on the books, is known as the book value of the shares.

A corporation, however, in order to reach its vast amount of stockholders, markets its stock through various channels. Although the value of the stock is basically depended upon the earning power of the corporation, yet, when the stock itself becomes a commodity on the market, its value then is governed by the basic law of the value of all commodities on the market: that is, supply and demand. The value assigned to stock in this respect is known as market value. We, however, are concerned with book value.

In view of the fact that a corporation may issue several kinds of stock, each carrying different special stipulations, before the book value of a certain kind of stock can be ascertained, it must first be known whether there are (and what they are) any preferred claimants to the net worth and what the residual value of the stock in question is.

There are many types of stock such as founders stock, guaranteed stock, etc., but whatever the name given, it has to do with the fact that some stock carries certain rights which the others do not.

The accounting problems in owners' equity in a corporation center about capital stock and surplus. First, there are the problems attached to capital stock and surplus; then the

handling of these elements in corporate activities: such as, the formation of the corporation, conducting of its affairs, and dissolution, brings a quite different set of accounting problems.

In discussing the accounting problems it will be assumed that transactions which require accounting for have all been properly sanctioned and authorized. The motivating forces which caused the various transactions will also be omitted. Thus no questions will be brought up as to why a certain set of facts have arisen. The attempt will rather be made to analyze the facts and in view of those facts discuss the accounting problems. In other words, the financial or managerial motivations for certain transactions will be entirely omitted; only the accounting problems coming in their wake will be taken up.

The first problems in accounting arising from capital stock is the proper handling of the authorization. On this subject there are two view points. Some claim that since the authorization of stock does not create any assets of definite value to the corporation but only gives the corporation the franchise to issue stock, this transaction should only be recorded as a memorandum on the books of the corporation. However, to retain a continuous perspective of the matter, it is better to make a formal record, in regular journal form, debiting Unissued Capital Stock and crediting Capital Stock Au-

thorized for the amount authorized by the state.

Subscription for capital stock may be made either before or after incorporation. A subscription to capital stock by an individual creates an inforceable claim against the same by the corporation. Since no stock may be issued until paid for in part or in full, to record this receivable on the books it is necessary to create an equity account to balance it. The equity account can be created by reserving from the authorized stock that amount of stock which has been subscribed for. Thus, Subscriptions Receivable is debited and Subscriptions Received or Capital Stock Reserved for Subscriptions credited.

A corporation in offering its stock for sale must set a value upon it. If the stock has a par value, that is the value for which it should be sold. However, it is not always possible to receive the par or face value and it is sometimes possible to get more than the face value. The sale below par creates a discount on sale of capital stock and the sale above par a premium on the sale of capital stock. Thus, there is a profit or premium and a loss or discount arising purely from the marketability of a corporation's own stock. How should they be recorded?

The acceptance of a subscription to a corporation's capital stock at less than par value frees the subscriber from any claim against him by the corporation for the difference

between the price value and the par value of the stock. The creditors, however, in case the corporation becomes insolvent, have a legitimate claim against the stockholders. In reality, the capitalization of a corporation, when a discount is allowed, is reduced by the amount of such a discount.

When stock is subscribed for at a discount at the time when the corporation is newly formed, the account, Subscriptions Receivable, is debited, for the amount actually agreed upon, Unissued Capital Stock credited, for the par value: and the difference is set up as a debit to Discount on Sale of Capital Stock. On the balance sheet this difference is deducted from Surplus, if there is any, or from the Capital Stock, if there is no Surplus. When stock is subscribed for at a discount at the time when the corporation has been in operation for a time, there may be some accounts against which this discount on the sale of capital stock may be charged directly. Such accounts are Premium on the Sale of Capital Stock, Paid-In Surplus, or General Surplus. The account, Discount on Sale of Capital Stock, may be, however, carried permanently on the books of the corporation and deducted from Surplus or Capital Stock, as stated before. Most owners, however, prefer to charge it off against surplus in order not to have it appear on the books constantly.

The premium on sale of capital stock should be credited to a capital surplus account or else set up as a special account.

Premium on Sale of Capital Stock. Finally, the balance of this account should be closed into capital surplus. Although some accountants balance this account off into General Surplus, it is best to credit it to a Capital Surplus, since the nature of the surplus arising from the sale of capital stock is quite different from that of earned surplus, as will be explained further later in this discussion.

The payment for stock subscribed for, however, is not really a problem in owners' equity. It is an exchange of a receivable for another kind of an asset. Payment, however, for stock purchased which leads to immediate issuance of stock is an entry affecting owners' equity. Such payment may be in cash, tangible or intangible property, or services.

The issuance of stock, however, is a problem in owners' equity. The entry to record this transaction depends upon how the entry for authorization was made. If it has been entered purely as a memorandum, then all that is necessary is to debit the cash or another asset account and credit Capital Stock issued. If, however, there has been a formal entry, debit Capital Stock Reserved for Subscription and credit Unissued Capital Stock; then in order to get the amount of Capital Stock Authorized the amount of Unissued Capital Stock and the balance will show the amount of Capital Stock Issued.

A separate set of accounts recording the authorization, subscription and issue of the various classes of stock carried

by a corporation should be kept. These accounts, as is true of Subscriptions Receivable and Capital Stock Issued, control subsidiary ledgers in which the individual subscribers or stockholders accounts are kept.

A stockholder, however, may not be able or desire to pay the balance on his installment or call stock and thus forfeit his right as a stockholder. The state statutes provide for the handling of such a matter. The provisions vary in different states.

Briefly, methods for handling forfeitures in default of payment may be divided into two classes. First, there is the complete forfeiture where the corporation acquires the stock: the stockholder is released from any loss which may be sustained; and he is not entitled to any gain which may result from the subsequent sale of this stock. Secondly, a stockholder may not be released, and a corporation may be required to return to him any gain or collect from him any loss due to resale of such stock. Expenses of reselling such stock should be charged to the sale.

In the first method, Capital Stock Forfeited is debited at par, while Subscriptions Receivable for the unpaid amount and Surplus from Forfeited Stock for the balance is credited. When that stock is sold, Cash is debited, if that was the consideration received, and the Capital Stock Forfeited account credited. If, however, the stock was sold at a discount, the

discount is charged against the Surplus from Forfeited Stock. All expenses are charged against the Surplus from Forfeited Stock. The balance, if there is any, in the Surplus from Forfeited Stock may then be transferred to Capital Surplus. There are other ways of handling it: the stock forfeited may be charged back to Unissued Stock if it had not been issued and then handled as if it were never issued. The surplus from forfeited stock may be credited directly to Capital Surplus. Any losses and expenses on that transaction will then be debited to Capital Surplus. If a premium arises from such a sale, it is finally credited to Capital Surplus. Whether there is a gain or loss, the company in this case is the beneficiary or the loser, as the case may be.

In the second method, there are various ways of handling the transaction. In the final analysis, it must be remembered that, in this case, if the sale nets more than the balance unpaid, the subscriber will become a creditor of the concern for that amount; if it nets less than the unpaid balance, the subscriber will become the debtor of the company for such a balance. The company is only the go-between. The simplest way to handle this seems to be to debit Forfeited Capital Stock at par and to credit Subscriptions Receivable for the unpaid balance and the subscriber for the remainder. When the sale is completed, the asset account for the consideration received should be debited and Forfeited Capital Stock credited. Any

losses and expenses incurred in this sale should be charged against the subscriber's account and any profit credited to his account. The balance if it be a debit should be transferred to a regular accounts receivable; if it be a credit, cash should be paid the subscriber.

There are other arrangements possible for the dealings with unpaid balances on subscriptions. It may be possible that a company is willing to issue stock for amount paid and to cancel the indebtedness in the balance. It may be advisable for a corporation to cancel the unpaid balance and to split the amount already received with the subscriber. He thus, sustains a loss and the company a profit. The recording should be in accord with agreements made; any profits resulting from such a matter should be credited to Capital Surplus or Paid-In Surplus and any loss debited against the same. The Subscriptions Receivable Account should be cleared, since it no longer exists as far as the particular stock in question is concerned. The stock forfeited should be charged back to unissued stock or set up as forfeited stock; and the account should be cleared when a sale of this stock is made.

This forfeited stock may be bid in by the company itself, if the offer on the market is not sufficient to make a sale advisable. The company in such a case must pay at least the unpaid balance. In so doing the stock becomes fully paid and can be considered as Treasury Stock. However, this does not

change the recording of forfeited stock. The profit from it is a Capital Surplus credit while a loss a Capital Surplus debit. The Forfeited Stock account is cleared and a Treasury Stock account set up at the par value of the stock.

Treasury Stock is stock which has once been issued for value and has come back into the possession of the corporation. Such stock may be either purchased or donated.

If it has been purchased, (this includes stock bid in as result of forfeiture) a price has been paid for it; and there are two conflicting opinions as to how such stock should be set up on the books. Some claim that it should be recorded and carried as an asset; others say it should be a deduction from Capital Stock Issued (or Unissued if the second method of recording is used).

As regards tha first opinion, it is true that to all appearances an asset has been acquired. If that money were paid for stock of another corporation it certainly would be an asset, why should then a different basis exist for the purchase of a company's own stock? This asset, on the other hand, is quite different upon careful analysis. All the shares of stock indicate is an evidence of ownership in the assets of a corporation. Thus, Treasury Stock is an evidence of ownership in a corporation's own assets. To set up such an asset on the books is rather incongruous. The only course then is to carry it as Treasury Stock deducting it from the Capital Stock

Issued to get the stock Issued and Outstanding.

Now comes the problem as to what value should be set upon it when entered as Treasury Stock. Some are of the opinion that the purpose for which it was purchased should be the ruling factor. If it were purchased for resale, it should be carried at the price paid for it or cash: if it had been purchased without intention to resell, it should be carried at par. There may be some merit to such a policy; however, if Treasury Stock is to be deducted from Capital Stock Issued, then it must be carried at par in order to have equal values for deduction. There is then only one way of valuing Treasury Stock and that is at par if it is to be represented as a deduction from Capital Stock Issued and Outstanding.

Treasury stock may be purchased at a premium or a discount. In such a case, either a Discount on Purchase of Treasury Stock or a Premium on Purchase of Treasury Stock account, as the case may be, should be set up. Upon subsequent sale of such stock any premium should be credited against an existing discount and any discount charged against an existing premium. Finally, the balances should be closed out to the Capital Surplus Account. However, the premium or discount on purchase may be at once recorded in Capital Surplus and any discount or premium on sale of same stock also cleared through the same account. The final result, whichever way it is handled is the same; in the first case, the separate transactions

are segregated until completed; in the second instance it is all merged into one at the beginning.

What influence has purchased Treasury Stock on Net Worth and the elements which constitute it: that is, Capital Stock and Surplus? Capital Stock has been reduced but so also have the assets by the amount paid for it. However, the reduction in the assets is not always commensurate with the amount of the lessening of Capital Stock, as is indicated by discounts and premiums resulting from such transactions. Therefore, purchased treasury stock may or may not influence net worth. Capital Stock is reduced, but it may result in an increased Surplus. Subsequent sales, with discounts and premiums, may bring the situation back to its original status. This should be borne in mind when the treasury stock is purchased for a definite purpose and it should be so disposed of as to obtain the desired result.

Donated Treasury Stock is a gift of stock by stockholders to the corporation. Being a gift, it is a surplus pure and simple. At the time of the receipt, therefore, it should be debited at par to Treasury Stock and credited to Capital Surplus. This will result in a decrease of Capital Stock and an increase of Surplus, since the net worth remains the same.

However, some clair, if Treasury Stock has been donated immediately after it has been issued for property, as in case of patents or mining franchises, it indicates that the prop-

erty for which it has been issued was overvalued, and, therefore, it should not be credited to Capital Surplus but to the Asset for which it had been issued. This will reduce the net assets.

Any premium or discount resulting from subsequent sale will have to be handled in a different manner depending upon the fact whether the credit had originally been to Capital Surplus or to an asset. If a premium has been acquired through the sale, and the credit had been to Surplus, it should be credited to Surplus; if the credit had been to the asset, it should be credited to the asset. In case of a discount, the debit should be to Surplus or the asset depending upon the original recording.

We see, then, that through the medium of Treasury Stock, Capital Stock can be decreased. However, such a state is temporary since the stock held as Treasury Stock may be resold. If Capital Stock is to be decreased permanently, there are several ways of doing it. This purpose is accomplished by cancellation of Treasury Stock, by decrease of outstanding or unissued stock, by retirement of purchased stock, by conversion of stock into bonds or one class of stock into another.

In the following entries it will be assumed that the original recording of stock is through a debit to Unissued Capital Stock and a credit to Authorized Stock and that Stock Outstanding is presented by the difference between Authorized

Stock and Unissued Stock.

Cancellation of Treasury Stock is effected through a debit to Unissued Capital and a credit to Treasury Stock. Cancellation of Unissued Capital Stock results through a debit to Stock Authorized on credit to Unissued Capital Stock. In neither of these cases is there a change in owners' equity as presented on the books.

A decrease of stock outstanding usually must be authorized by an unanimous vote of stockholders and official approval by the state. It is carried through on the books simply by debiting Unissued Capital Stock and crediting Paid-In or Capital Surplus. A decrease in stock outstanding produces a decrease in Capital Stock and an increase in Donated or Capital Surplus. The net worth remains the same. The stockholders give up a part of their ownership and receive nothing for it.

Retirement of purchased stock could be above par or below par. This situation, of course, brings up again the problem of discount and premium on capital stock. Debiting Unissued Capital Stock and crediting Cash (since this is usually the consideration paid) will take care of the adjustment on the books to record the retirement of the stock. As far as the premium and discount are concerned in such transactions, the premium should be debited against Capital Surplus and the discount credited. (The seemingly reversed entry, as regards

premium and discount on capital stock, is due to the reason that the corporation now stands in the position of purchaser instead of seller, as is the usual procedure). Owners' equity has decreased through the reduction of Capital Stock Outstanding: the individual stockholders, however, have been reimbursed for the submission of a share of their holdings.

Conversion of one class of stock into another will increase one and decrease the other. The entry on the books is simply a debit to Unissued Capital Stock of the particular class which is being decreased and a credit to the account of the stock which is being increased as a result of the conversion. Conversion of par value stock into no-par value stock will be discussed under the topic of no-par value stock. The net worth is not affected; the relationship among the different classes of stockholders has changed. Conversion of capital stock into bonds reduces stock outstanding and creates a liability. Net worth is reduced and so is owners' equity.

An increase of Capital Stock is also accomplished through various manipulations; such as, increase in authorization, issue of unissued stock, sale of Treasury Stock, conversion of bonds into Capital Stock. The journal entries to record these are simple and will not be listed. The result is an increase in net worth and a possible change in the individual stockholders' equity in the assets.

When stock is increased, old stockholders, to preserve

their original status, are entitled to purchase as much of the new stock at the price offered as will give them the same rights in the increased capitalization as they had in the old one. Such a right is known as a stock right. To set this option to purchase new stock, to old stockholders, on the books of the corporation is unnecessary.

In order to have such stock available, however, without increasing its authorization, a company may reserve some unissued stock. There are also various other reasons for reserving capital stock. The only entry required is a debit to Capital Stock Authorized, and a credit to Capital Stock Reserved. It is well to designate the purpose of such a reserve by a proper name.

Thus far, our discussion of capital stock has dealt with par value stock. What effect do the various manipulations of capital stock, described heretofore, have on capital stock without par value?

As has been defined before, no-par value stock is stock without a dollar value, while par value stock has a definite money value. Theoretically, all considerations received for par value stock should be worth the face value of such stock. In reality, however, the values offered for it are adjusted as well as possible to the face value of the stock issued for it. Such means need not be resorted to in case of no-par value stock, since it gets its value from the value of the consider-

ation for which it is issued.

But this simple theory underlying the value of no-par value stock is not always understood and in recording capital stock of no-par the question as to the value at which it should be carried on the books comes up. It is further complicated by the lack of uniformity in different states governing this type of stock as well as the uncertainty of just what is "Capital Stock".

Capital Stock, fundamentally, is that portion of owners' equity which is invested by the stockholders for the purpose of carrying on business and must remain intact for the protection of creditors who deal with the corporation on the strength of this stated capitalization. In the case of par value stock, Capital Stock is the value of the stock outstanding. From the facts given before, we know that is not always true, since premiums and discounts on capital stock are utilized in order to give this illusion. However, disregarding these, Capital Stock, in event of par value, equals the amount of stock outstanding.

Because the public has become so accustomed to par value stock, the same principles are being applied to no-par stock in many cases. We have, therefore, such rules as "stated value", that is the value paid for such stock which should be recorded as Capital Stock. Thus, if more is paid than the stated value, there is a premium and if less there is a dis-

count. Furthermore, some allocate the amount paid for such stock between Capital Stock and Surplus.

Yet, in order to preserve the essence of no-par value stock, it should be recorded at the price paid for it. This means that each block of capital stock will sell for a different price and should be recorded at that price. The fact that some stockholders will pay more for the same kind of stock does not change this principle. It may be that the higher price paid is due to an accumulated surplus which the new stockholders will share with the old.

Carried at the price paid for it, Capital Stock of no-par value eleminates premiums and discounts on sale of stock.

The authorization must be in terms of number of shares, since there is no value to such shares until they are offered for sale, and recording of same can only be as a memorandum entry.

Subscription, of course, is entered at the price at which it is offered for sale; otherwise the journal entry is the same as in case of par value stock. The same is true of the accounting for receipt of payment for same. In the issue, of course, the debit will be against Subscriptions Received and the credit Capital Stock Issued, since there was no journal entry for the authorization.

In case of forfeiture of stock of no-par value, if the shareholder is released, the profit or loss resulting should

be recorded in the Capital Stock account, in order to reflect the exact amount paid for such stock. Where the forfeiture does not release the stockholder, the profit is returned to and the loss charged against him. However, if the company should be unable to collect this balance, it should be charged off against Capital Stock. We see, therefore, that in the case of par value forfeitures, Surplus is influenced by the various transactions; with no-par value stock, Capital Stock is affected.

As to Treasury Stock of no-par value, the occurrence of donated stock is rare. Purchased Treasury Stock, however, should, theoretically, be carried at the amount which was originally paid for it. Any premium arising therefrom should be credited and any discount debited to Capital Surplus. When the Treasury Stock is resold, the premium and discounts thereon resulting are adjusted through the Capital Surplus account.

However, because of the difficulty in ascertaining the price originally received for such stock, for all common purposes, the value assigned to the stock on a weighted average received for all units at different prices, serves as well.

Because of the nature of no-par value stock, increases and decreases do not really present any accounting problems, since the number of shares are affected, not the value of the same. Its value, it must be remembered, is the value of the net assets at that time.

Occasionally, to make an offer of preferred stock more attractive, no-par value stock may be given with it as a bonus. What value should be set upon such shares issued? The directors usually decide this question in view of the law governing same.

They may decide to divide the price paid for such a combination between the preferred stock and the no-par value stock in a certain ratio. They can, however, authorize that only a memorandum be made of this issue increasing the no-par value stock outstanding in order to avoid the setting up of a discount on the preferred stock, since such would be the result. It must be borne in mind that the no-par value stock outstanding has increased in either case and that in the future, the stockholders, who have received such stock as a bonus, will share with the others, even though they did not pay for it while the others have.

Conversion of par value stock into no-par causes the problem of recording the value of no-par stock. There are various opinions on this subject. Some claim that the price originally paid for it should be the one at which it should be entered; others, that the value of the net assets (that is, Capital Stock plus Surplus) should be the amount recorded. There are various other modifications. In the final analysis, the problem resolves itself into two questions. First, when par value stock is exchanged for no-par, is it merely a change

within the same organization or is the change due to a change among owners?

Following the principle that no-par value stock should be recorded at the consideration paid for it, in the first instance, the actual amount paid (inclusive of premium or discounts of the par value stock being so converted) should be the price entered as the value of the no-par stock; in the second case, the value of the net assets, would be the amount, since, no doubt, that must have been the intention of the buying corporation.

However, the facts in each case should be the deciding factor in the decision.

Capital Stock is only one of the components of Net Worth; the other is Surplus. Surplus, as explained before, is the excess of Net Worth over Capital Stock. How does it come about? It is acquired through corporate activities. If we review briefly the various transactions possible in the handling of Capital Stock we notice that in most of them there is a difference between the Capital Stock recorded on the books and the actual amounts paid for it. There is the "overage" resulting in the original sale of stock known as premium, then there is the profit from forfeitures under certain existing arrangements. We also have an increase in net worth through the operation of Treasury Stock. Decreases, conversions and retirements of stock (or bonds) may bring about a profit.

Furthermore, a going business may be bought by the corporation or it may be merged with another and again there may be a resulting profit. What is the nature of this profit? In most of these cases profit, so to speak, presents itself through the manipulations of capital stock. This surplus, then, can be called Capital or Paid-In Surplus.

Every business is organized for profit. This profit which is realized through increases in the net assets is due to the operation of the company's business. It is an excess of income over expenses during a certain period. It is the amount which is transferred to Surplus when the Profit and Loss account is closed for the period. This accretion in Surplus is known as Earned Surplus.

A surplus addition may also result from the revaluation of the assets. However, bearing in mind, that no company should take as a profit any amounts which were not actually realized through the operation of the business, it is impossible to include the result of a mere book "write up", even if it is the market value, in Earned Surplus. It should be set off as a Surplus resulting from Revaluation of the Assets.

But the corporation may find it advisable to sell fixed assets which it no longer needs, and may get a profit on it. Where should this profit be credited? Some claim that this profit should be credited to General or Earned Surplus. However, it is never advisable to bring extraordinary profits

into operation profits, and it is best, therefore, to segregate this surplus as Surplus from Sale of Assets.

Some corporations are invited by undeveloped communities to locate their sites in these localities, and as an attraction are offered certain franchises or property. They are gifts pure and simple. The company paid nothing for an acquired asset and has therefore an increase in assets and a corresponding increase in net worth. What sort of a surplus is this? Since to credit the amount of the value or the asset to general or earned surplus will obscure profits due to operation, it is better to set it off as Surplus from Acquisition of Donated Property.

But a company may meet with reverses and so reduce its Net Worth that it will be less than the value of the Capital Stock. Such an unfavorable balance is known as a Deficit.

Surplus does not mean that a corporation has an excess amount of any one asset. All assets are merged into one total amount. Surplus is an equity in all the assets. However, certain assets may be segregated for special funds.

A company for various reasons sometimes sets aside certain amounts of surplus for special purposes. The recording is simple. General or Earned Surplus is debited and a special reserve account, properly labled, credited. These reserves are a part of surplus but are set aside to prevent their being declared out as dividends. If assets are segregated for these

reserves, such assets are known as "Reserved Funds".

These surplus reserves must be distinguished from valuation reserves which are really credits to certain assets which, as a matter of policy, were not written down to their present value. Depreciation Reserves for Bad Debts or for Fixed Assets are of such a nature.

Aside from quite the distinctly designated reservations of surplus, there may also be created, intentionally or unintentionally, reserves known as "hidden or secret reserves". This may be accomplished through undervaluation of assets, overvaluation of liabilities, in the form of too great valuation reserves, or the charging to expenses of amounts which should be recorded as assets.

What corporate activities necessitate the manifold utilization of the very pliable mechanism, capital stock (as represented by its shares of stock) and its accompanying element, surplus? Briefly, they may be classified under the following captions:

1 The formation of the corporation

2 Declaration of Dividends

3 Financial readjustments

4 Reorganization

5 Dissolution

A corporation may be newly formed or an old going business incorporated. This going business may have been a

single proprietorship, a partnership, a corporation or any other business organization. Each incorporation brings its own peculiar problems.

The charter authorizing incorporation is obtained from the state by filing an application with proper state officers, payment of a statutory fee, and approval of same by the proper state officer in authority. Usually, no less than three individuals are permitted to incorporate.

The accounting problem in such an incorporation is really accounting for authorization, subscription, sale, payment for, and issuance of capital stock, with the concurrent factors, premium or discounts on sale of capital stock, and forfeitures.

The only new problem which arises is what to do with so to speak organization expense or expenses incurred in the formation of the business. It is usually set up as a deferred charge and charged off against surplus over a period of five years. It may, however, be carried on the books throughout the life of the corporation. But, since it is not advisable to carry an undesirable charge indefinitely, it is best to charge it against capital surplus if there is one, or against general surplus.

If a going concern is incorporated, the properties should be revalued and a decision arrived at whether or not good will should be set up. The advisability of setting up good will is decided upon the same principle here as in all instances where

a going concern is purchased; that is, has the business purchased a superior earning power which could be capitalized. If it is set up on the books, the assets of the business are increased and this increase is reflected in the net worth of the newly incorporated concern.

If a going concern has been incorporated, and no provision made for the payment of the liabilities, the creditors may follow the assets. The acquisition of the assets, then, carries with it the necessity of the assumption of liabilities.

In the incorporation of a single proprietorship, partnership or another corporation, aside from the usual opening entries in a new corporation, there is also the necessity of recording the acquired assets and assumed liabilities. Since the incorporation of an existing corporation will be better understood after a few more corporate activities are taken up, and discussion regarding it will be postponed for the present.

To resume, the simplest method, to bring the assets and liabilities onto the books in the incorporation of a proprietorship or partnership, is to debit all the assets and credit all the liabilities, inclusive of the capital accounts. The entries of the authorization and subscription of the stock are presumed to have been made. Subscriptions Receivable are then credited and the capital accounts debited, to record the payment of these subscriptions by the acquisition of the business. When stock is issued the Stock Reserved for Subscrip-

tion account is debited and Unissued Capital Stock credited.

It is well here to note that in the incorporation of a partnership or proprietorship, there may be a desire by its former owners to retain their old relationships in the new corporation. The flexibility of the mechanism capital stock can make the fulfillment of such an intention possible. "By the use of common stock, with or without par value, preferred stock of varying powers and privileges, and bonds, almost any requirements of a partnership (or proprietorship) incorporated may be satisfactorily met." [1]

The numerous requirements and the various handling of corporate securities to fulfill them, if discussed here, will only confuse matters. Each case must be decided in the light of its own facts. However, if the mechanism of capital stock is thoroughly understood and if the facts in each case are properly analyzed and segregated, the accounting problems therein involved are not difficult.

Business is organized for profit. Both from the point of view of the corporation and the stockholder it is desirable that these profits be passed on to the proper owners. The only way stockholders of a corporation can get at the profit is to have the directors declare it out in dividends.

Dividends may be declared, as a general rule, only out of earned surplus, although some states do not designate the source of surplus out of which dividends may be declared.

1 Conyngton, Thomas & Bennett, R. J. Corporation Procedure Pg. 793

However, if dividends are declared out of any other surplus, the fact should be designated. In a business, such as mining or timbering, depletion dividends may be declared; such dividends are really a return of Capital Stock.

The declaration of a dividend creates a liability on the part of the corporation and the stockholders have a creditor right to the extent of the dividend declared. To record a declaration of a dividend, debit Earned Surplus and credit Dividends Payable. If the declaration of the dividend has been partly out of Surplus and partly out of Capital Stock, the amount declared should be charged to each respectively in proportion to the amount declared out of each.

Dividends may be paid in cash, property, script, bonds, or a corporation's own stock.

If payment is made in cash or property, dividends Payable is debited and the proper asset credited; if paid in script or bonds, the debit is to Dividends Payable and the credit to the proper liability since both are promises to pay. Payment in a corporation's own stock is accomplished by a debit to dividends Payable and a credit to Unissued Capital Stock or Treasury Stock.

A declaration of dividends causes a reduction of Surplus and net worth; the payment of dividends may carry through this condition or not. If the dividends are paid by a reduction of an asset, as in case of cash or property, or by the creation

of a liability, as in the event of script or bonds, dividends do reduce net worth. However, if capital stock is paid, the net worth remains unchanged, the resulting effect is a transfer of an amount of surplus to Capital Stock.

Dividends on par value stock are expressed in terms of percentage which the dividend per share is to the par value per share. Cash dividends in no par value stock is expressed in so many dollars and cents per share. Stock dividends on no-par value stock are expressed in percentage which the amount of shares declared as dividends bear to the total number of shares.

In payment of dividends in no-par value stock, the directors may designate what amount should be transferred from surplus to capital stock; or no transfer out of surplus may be made. In the first instance, the entry is the same as in par value stock; in the second case, all that can be recorded is a memorandum of the amount of shares issued as a dividend. The result is a split up in the book value of the stock.

A corporation once organized may find that its "corporate structure" is not "well-balanced". That is to say, its complete corporate capitalization is not well suited to the requirements of the business. This may be changed either through readjustments of the various securities of which the "corporate structure" is composed with or without the aid of a receiver, or through reorganization. In the first instance,

the company remains the same; in the second, it is dissolved and another corporation is formed in its place.

The necessity for readjustment may come about either through a desire for further expansion or growth or through an attempt to adjust the "financial structure" of the corporation to the business. The reasons motivating such actions are too numerous and varied to discuss here. They may be caused by economic, managerial, or financial considerations. However, in the final analysis all the causes resolve themselves into two distinct accounting problems:- first, an attempt to increase the capitalization, and second, a move to decrease it. The accounting problems, therefore, in readjustment, are problems in increase or decrease of capital stock.

A deficit may be wiped out and even turned into a surplus by a decrease of stock which could be accomplished through donation of stock or decrease of outstanding stock. Conversion of par value stock into no-par value stock will eliminate a deficit. A large surplus, which may lead to an attempt to have it declared out in dividends, may be reduced by increase of capital stock outstanding or a payment of a stock dividend. Too burdensome an expense of interest on bonds may be reduced by conversion of the bonds into stock, while too great a drain due to preferred stock may be overcome by its conversion into common.

These are only a few of the possibilities. To review

all possible readjustments and "transwrite" the same into journal entries will neither take care of all the multitudinous cases nor elucidate farther the accounting problems in Owners' Equity regarding them. All that is necessary is a knowledge of the facts presented and a complete understanding of the mechanism, capital stock. The accounting entries should reflect the agreements.

However, not always, can readjustments be accomplished through amicable agreements among various holders of a company's securities. Often a readjustment is possible only through the aid of a receiver. This may be done voluntarily or involuntarily by the various parties concerned. The procedure in either case is the same until the receivership is dismissed.

As far as the conducting of the books by the receiver is concerned, the accounting problems in Owners' Equity or rather accountability comes under fiduciary accounting and will not be considered here.

As regards the corporation books, there may be one of the two methods adopted: first, the books may be left in the condition they were when the receivership was appointed; second, the books may be adjusted periodically to agree with those of the receiver. The receiver may open new books or use the books of the corporation.

Whether the books are abandoned during a receivership or

whether they are periodically adjusted, finally they must be brought into accord with the results of the receivership when it is dismissed. Of course, the result of a receivership may be a tremendous reduction of values. The books must properly reflect this condition. The assets must be written down to their new value, the liabilities, discharged by the receiver, cleared. Any losses sustained by the receivership adjusted to Surplus.

The holders of a company's securities (stocks and bonds) have two alternatives now: they may either come to an agreement and readjust the capitalization of the corporation for the purpose of conducting the business; or they may liquidate the remaining assets, dissolve the corporation, and distribute the realized funds among themselves in proportion to their claims and holdings.

If the purpose of the appointment of a receiver had been in order to liquidate the assets and dissolve the corporation, the receiver may have liquidated all the assets, paid all the creditors (preferred and others), and returned the balance of the cash to the corporation. The stockholders would then have appointed one of their members to take care of the dissolution of the corporation and the payment of liquidating dividends.

Thus, if the business is to be continued, the accounting problems in owners's equity are those of readjustment; if

it is to be discontinued, the problems are those of dissolution.

Dissolution does not present any difficulties in accounting. It is in fact quite simple. The assets are realized into cash, liabilities and expenses paid and the balance distributed among the stockholders in proportion to their holdings. Any losses or profits through realization of assets is closed into Surplus. The source of surplus is not important in a liquidating dividend. Payment is made in proportion to holdings. If there are several classes of stock, preferred stock, which is preferred as to assets, gets its share before payments are made on other shares.

However, dissolution of a concern may result when a going concern is sold. It may be sold for cash or for stock in another going concern. As in the event of all sales of going concerns, the problems of revaluation of assets and good will present themselves. The assets should be adjusted to their newly appraised values and any shrinkage debited or "overages" credited to Surplus. Good will should be debited and Surplus credited. An account should be opened with the purchasing or vendee company. The assets should be credited and the vendee company account debited with the sum total. The liabilities should be debited and the Vendee Company account credited with the total amount. Cash or Security Account debited for the consideration received for the net assets and the Vendee

Company account credited. The above entries close out the assets, liabilities, and Vendee Company account. The only accounts left open are Cash or the Security accounts, carrying the consideration received, and the equity accounts of the owners (Capital Stock and Surplus). As liquidating dividends are made, the consideration paid is credited and the equity accounts debited. When the last liquidating dividend is made and recorded, the books of the corporation are closed.

When cash is paid for a going concern, it may happen that only the assets are purchased and the retiring company itself pays its indebtedness and then distributes the balance among its stockholders. However, there is no new accounting problem here.

Of course, final dissolution must be permitted by state authorities; however, this is only a legal procedure. When the books of the corporation are closed, dissolution is effected in fact.

The absorption of a going concern by another company brings us to the accounting problems in Owners' Equity connected with mergers or consolidations. A merger is the absorption of a going concern by another one; a consolidation is the formation of a new corporation for the purpose of combining several going concerns into one. In the final analysis both forms of combination are alike, except that in the case of a consolidation a new corporation is formed while in

a merger an old company swallows up an existing one. However, in either case, the absorbed businesses are dissolved. Through this form of combination, whether merger or consolidation, the result is one entity.

Payment for the absorbed business or businesses may be either in cash or in securities of the absorbing concern to the owners of the absorbed corporations. Since in the first instance, the stockholders of the absorbed company are no longer connected with the business, some claim that this is merely a purchase and not an absorption or merger. However, in reality it makes no difference what name we give it; in fact it is a merging of one business with another.

A company may have ready cash with which to buy a going business and thus the merger will really not cause any problems in owners' equity. All that has happened is that the company has exchanged one asset (cash) for another (the properties of the going concern). Such cases, however, are rare.

Usually, whether it be a merger or consolidation, there is a demand for recapitalization. In the first case, it is a problem in readjusting the financial structure to meet the new needs for funds; in the latter, it is the formation of a corporation to accomplish the same end.

The first problem in accounting, therefore, in case of mergers or consolidations is in the first instance, readjusting entries to record the new capitalization; in the second,

the entries necessary in the formation of a corporation: that is, authorization, sibscription, sale, payment for, and issuance of, the stock.

The second problem in accounting presented by a merger or consolidation is similar to that of an incorporation of a going concern; namely, the acquisition of assets and assumption of liabilities.

The last problem is payment. If it be in cash the situation is simple; if it be in securities, the problem presents itself as to the distribution of capital stock to the various owners of the absorbed corporations. "In making the allotment of securities, the fundamental rule is to distribute the securities in such a way-------that each old company or its stockholders will receive the same"[1] security in exchange which it has surrendered at the time of absorption.

It must be remembered that shares of capital stock represent a right in income, in assets, and a voice in the management. All these three should be borne in mind in the allotment of securities.

To take up a specific case for demonstration which will illustrate all situations is impossible.[2] To give specific instances may obscure the facts and principles. Furthermore, to list many calculations and computations in order to equalize the value of one kind of security expressed in the terms of another company would be a sufficient subject for particu-

lar discussion. Suffice it to say, that the realization of the existence of such a problem and its cognizance by interested parties will lead to proper decisions among the interested parties. The accounting problem, then, is to properly record such agreements.

Consolidation or merging usually results in greater capitalization and a change in owners' equity through the possible adjustments described above.

Combinations of various concerns may also be effected in other ways. Disregarding, however, all combinations which do not result in accounting problems, we have, beside the merger or consolidation the following two:

1 Combination by acquisition of controlling interest in a corporation through purchase of capital stock in said company.

2 Combination by leasing of property of one or more concerns.

Combination by lease presents no particular problems in owners' equity. Like all leases, it is the use of property by payment of rentals for a definite period.

Corporations who own a controlling interest in another company's capital stock, are known as holding or parent companies. Such combinations may be brought about either by a new corporation being formed for the express purpose of controlling others through its ownership of a majority of their

capital stock or by an existing company's acquisition of a majority of stock in one or more concerns for purpose of control.

The distinguishing earmark between a holding and a parent company is the purpose for its acquisition of the controlling portion of another concern's capital stock. If the sole purpose is to direct the controlled companies, to collect the dividends from same, to pay its own expenses and redistribute the balance of its income through dividends to its own stockholders, the corporation is a holding company. If, however, the purpose for control is to get the business, since for various reasons it may have been unable to buy it, the company owning such stock is a parent company.

However, the terminology in regard to various combinations has not yet been clearly defined and others may use the terms differently. Furthermore, it will be noted that the distinguishing factor between a consolidation or merger and a holding or parent company is that, under the first form of combination the assets or the business is owned; under the latter, the controlling interest in Net Worth is acquired.

The controlled concerns are known as subsidiaries.

The accounting for a holding or parent company, as far as the books are concerned, is quite simple. There is no change on the subsidiary's books; except in the Stock Ledger, where the change in stockholders is recorded. As to the parent or

holding company, discounting the possible entries for readjustment of the capital structure, the only entry necessary is a debit to Securities of Subsidiary at cost and a credit to cash or capital stock, depending upon the consideration paid.

It should be noted, however, that holding or parent company combinations present some problems in accounting for owners' equity. It is an investment and is recorded as any other one. However, on close analysis it will be seen that it is an investment of a different nature. The parent or holding company can through the control of the directors do anything it pleases with the controlled corporation; it may declare out dividends, or even sell its assets to itself.

Furthermore, securities recorded at cost on the books of the parent or holding company may differ a good deal from the book value of the proportionate share of Net Assets controlled. This may lead to the anomoly of a prosperous appearing parent company being in financial difficulties through losses of a subsidiary, which of course are not shown on its books.

Holding or parent companies do, therefore, present definite problems in owners' equity which are the more difficult because they are not apparent.

Some, therefore, advocate that the parent or holding company's books should indicate the condition of its subsidiaries. How should the books be adjusted to reflect a subsidiary's changing Net Worth? The proposition is made (through several

methods) that the investment in subsidiary account should be periodically adjusted to the book value of its proportionate share of the subsidiary's Net Worth. Such recording, however, is neither in accord with law nor good accounting. The parent or holding company and its subsidiaries is not one but separate entities.

Furthermore, it complicates and obscures facts and makes the handling of same difficult. It also distorts the books.

To judge the affairs of any one concern at one time merely through its book records is impossible as well as incorrect. Realizing this situation, accountants have developed records outside the books in order to summarize the various facts and present them into a comprehensive whole. This is done by means of financial statements.

Adjustments, therefore, in owners' equity as regards holding or parent companies, should be in records outside the books. The, so to speak, Consolidated Balance Sheet seems to be the best place to record owners' equity in this case.

What are some of the problems? First, we have the question of good will. If the cost of securities is more than their book value, it is presumed that there is a consolidated positive good will; if it is less, then there is a negative good will. Is this negative good will a profit and should it be recorded as a consolidated surplus? The answer varies with the facts. If the lesser price paid is due to a good "buy"

by the parent company, then it should be recorded as a consolidated surplus; if it is due to an inflated condition of the subsidiary's asset, it should be set up as a Reserve for Revaluation of Investment in Subsidiary.

Matters may be further complicated if payment for securities is made in the capital stock of the parent company. Through this transaction the subsidiary has become an owner of the net worth of the parent company. What value should be set upon the securities?

Furthermore, a parent company may deal with its subsidiary and thus there may be on the books of both intercompany dealings and profits.

In the working papers for the preparation of the Consolidated Balance Sheet recognition could be made of these facts, since the purpose is to eliminate the investment account on the parent company's books and substitute for it the proportionate share of the assets of the subsidiary to which the holdings by the parent company entitle it.

Since financial statements have been completely omitted here, a further discussion of the Consolidated Balance Sheet will not be made. Suffice it to say, that the Consolidated Balance Sheet will after various eliminations show a true picture of the parent company through its combined assets, liabilities and net worth accounts. The rights of the minorities will have been segregated and shown either as a liabil-

ity of the consolidation or in a special section under the Capital Caption. The purpose will have been accomplished, since the combined Net Worth less the minority interest will show the parent company's equity in the combined assets.

To go back to the books of the parent or holding company, there are two facts which have been omitted. The investment account in the subsidiary, being an asset, could be revaluated to reflect the book value or market value of securities of the subsidiary. This could be accomplished by a "write down"; that is a credit to the investment account and a debit to surplus. This, however, obscures the price paid for such stock. It is better to debit (a revaluation) surplus and credit a Reserve for Revaluation of Investments in Subsidiary, (that is, a revaluation reserve).

As regards the dividends received from subsidiaries, any dividends which were declared out of earned surplus acquired after the purchase of the securities should be debited to Cash and credited to Income from Investment in Subsidiaries. This income should be at the end of the period closed through the Profit and Loss account into Earned Surplus. Any dividends declared out of surplus accrued prior to acquisition of the stock by the parent company, should be credited to the Investment account in order that it may reflect the real price paid, since, no doubt, the price paid for it was in recognition of this fact.

To sum up the accounting problems in owners' equity in a corporation we can divide them up into three distinct divisions.

1 The problems connected with the mechanism capital stock and its component surplus.

2 The problems connected with the various financial activities utilizing the above.

3 The problems in valuation of assets and securities brought about by the various corporate activities and their mathematical computations.

If the facts in each case are segregated and analyzed in respect to the whole, the accounting problems in owners' equity in a corporation are no more difficult than in any other business organization. The multiplicity of possibilities, however, unless analyzed, may create perplexing complexities. If a thorough knowledge of principle applying to each problem is borne in mind, however, and not confused by particulars or obscured in generalities, the accounting problems are simple.

The accounting problems in owners' equity in other business organizations are really modifications of the corporate ones or a combination of corporation and partnership problems.

The so-called, Massachusetts Trust, is really a modification of a corporation. The organization is accomplished through a declaration of trust. This declaration usually

embodies the provisions contained in a charter of a corporation. The certificates of beneficial interest take the place of stock certificates; they are transferrable and may be either common or preferred.

Of course, the source of all authority for action is the declaration of trust which is similar to the articles of copartnership in a partnership. However, the trust may sue and be sued in its own name. This fact gives it a little of the natural person aspect of a corporation.

We have thus reviewed the various accounting problems in owners' equity under the most common existing forms of business organization. A knowledge of the principles of debit and credit in accounting has been assumed. An attempt has been made to avoid particularites or specific examples in order not to obscure the basic problems and principles underlying them. The endeavor has been to get a familiarity with the subject as a whole so as to be able to analyze specific cases and adapt them to the mechanisms provided for their execution or apply the same in particular situations.

If the subject of Owners' Equity has been at all simplified as well as clarified, the object of this thesis has been accomplished.

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Almost all of these books and the articles were read in their entirely and used constantly in connection with the writing of the thesis.

Furthermore, use was made of the class lecture notes in some of the courses, especially those taken in Accounting 41 & 42.

Not to be taken from this room