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Speeches. SEC staff

"SOME CURRENT PROBLEMS IN ACCOUNTING"

ADDRESS

of

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Your president has invited me to select from the everyday business of the SEC some frequently recurring situations not as yet controlled by well-defined accounting principles. Reconnaissance of the ground and preliminary skirmishes seem unnecessary for most of you are well acquainted with us and some of you have cooperated in our work.

Problems involving surplus have continued to accumulate since Judge Healy addressed our Association at Atlantic City. A large number with considerable variety have to do with the distinction between capital surplus and earned surplus. As a text around which to build a discussion of some of these problems, I take the second of the five general accounting principles listed by a special committee of the American Institute of Accountants in a report to the Committee on Stock List of the New York Stock Exchange:

"Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would be required to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization."

This principle was announced in 1932. In 1936 A Tentative Statement of Accounting Principles prepared by the Executive Committee of this Association included essentially the same propositions in items 17 and 19. You recall that item 17 reads, "Neither paid-in surplus nor surplus reserves should be availed of for the absorption of losses. Charges for all cost amortization, losses recognized, and other asset values expired should be by way of the income account to earned surplus;" and that item 19 states that, "Where by proper corporate action a deficit has been absorbed through a reduction of par or stated value of capital stock or by transfer to paid-in surplus, earned surplus thereafter should be so labeled as to indicate that it dates from a point of time subsequent to the inception of the corporation."

This principle was followed in the first of the Chief Accountant's opinions announced on April 1, 1937. Mr. Blough in that release expressed the principle in these words: "It is my conviction that capital surplus should under no circumstances be used to write off losses which, if currently recognized, would have been chargeable against income. In case a deficit is thereby created, I see no objection to writing off such a deficit against capital surplus, provided appropriate stockholder approval has been obtained. In this event, subsequent statements of earned surplus should designate the point of time from which the new surplus dates."

Quasi-Reorganizations

The restatement of capital and absorption of an operating deficit with stockholder approval but without the creation of a new corporate entity has been termed a quasi-reorganization. The development of the principles applicable to such cases has brought a number of interesting problems before us in recent months.

I believe the exception appended to the general rule is founded on the fact of consent by all concerned to the taking of a new point of departure. To be otherwise than illusory, it seems to me that such consent must be given only to the specific transactions proposed and only after full and fair disclosure of all the circumstances. However, this vital characteristic of the procedure has often been lacking. In connection with a recent offering of securities a copy of a letter addressed to stockholders came to our attention. The letter disclosed that a transfer from capital to capital surplus had been ordered by the directors five years before without any approval whatever on the part of the stockholders. As a result, for five years the corporation had shown its stated capital at $3,000,000 less than the legal capital as defined by the laws of the state in which it was incorporated.

In another instance a listed company extinguished its operating deficit by transferring it to surplus resulting from a reduction of stated capital. This action was taken pursuant to a resolution of the board of directors and was so reported in the analysis of surplus included in the annual report sent to stockholders and filed with the Commission. Since it was not clear from the report whether the stockholders had approved of using capital surplus in this way a deficiency was cited. Accountants for the company replied by quoting the state law to the effect that a reduction of capital must have the approval of the stockholders but that the directors have the authority to write off deficits or losses provided disclosure is made in the next annual report to the stockholders. If the principles underlying the accounting concept of a quasi-reorganization and the distinction drawn between capital and earned surplus can thus easily be evaded, it seems questionable whether that procedure and that distinction can long be maintained.

Assuming that specific stockholder approval is the first step in a quasi-reorganization, the next may be the question of the values to be carried forward. The procedure we are discussing rests on the assumption that if a corporation finds itself possessed of overvalued properties, an operating deficit or both, it is cheaper to cure the situation by obtaining consent of stockholders to restate capital, mark down the assets or write off the deficit in a simulated reorganization than it would be to create a new corporate entity.

In view of the general rule, it seems implicit in such a procedure that reductions in the carrying value of assets may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relatively permanent reductions in asset values, as for example, complete or partial obsolescence, over capacity, lessened utility value, undue costliness in operation, or in the case of current assets, declines in indicated realization value.

The question is sometimes raised as to whether subsequent to the effective date of the quasi-reorganization, the basis of restating the assets may be changed. Such a problem is in effect raised whenever a charge is proposed to be made against any balance of surplus arising from the reduction of capital, although if the quasi-reorganization had not been effected, the charge would have been required to be made to earned surplus

or income. In some cases, where inherent losses are indeterminable in amount at the time of the quasi-reorganizations, such a charge may be justifiable. On the other hand, if the integrity of subsequent earned surplus is to be maintained, it would seem that the values established ought to be conclusive. In one case, for example, no reductions had been made in certain investments. Some three years later it was proposed to establish a reserve against these investments by a charge to capital surplus on the ground that such a reserve should have been established at the time of the quasi-reorganization. After discussion, however, the charge was finally made to earned surplus since it could not be shown that the losses were due to conditions existing at the earlier date.

Cases similar to these occasionally arise although a new corporate entity has in fact been created. In such cases the problem turns on whether the values established at organization may be restated without eliminating earned surplus and despite the fact that these values have appeared on published statements without comment.

In a case which focussed our attention on this question, the corporation had carried its plants at values shown on a predecessor's books. After several years the stockholders approved a restatement of capital and the writing off of part of the property against the capital surplus created. At the time these transactions took place an earned surplus existed but was left undisturbed. On examination of its annual report a deficiency was noted for failure to exhaust earned surplus before using capital surplus for the write-down of the plants. The company protested that the change demanded by us would be misleading because it would conceal the company's earning power and particularly because the plants written off, while taken over at values on the predecessor's books, actually had no value at that date. Hence it was argued that the entry was correct as it eliminated valueless assets by charges against an overstated capital. On the other hand, the showing of the higher values on balance sheets for nearly a decade seemed to warrant a presumption that the value had been lost during that period and hence the charge should have been to earned surplus with any resulting deficit carried to capital surplus only under the safeguards of a quasi-reorganization. The solution finally reached permitted the company on the basis of written representations to file corrected statements with an admission of the misrepresentation of value prior to the restatement of the assets.

A third problem of some difficulty is the question of what type of reserves may be established at the time of eliminating a deficit. If earned surplus exists it is generally recognized as conservative to establish reserves therefrom in anticipation of losses which may reasonably be expected to occur at some time in the future. Is it equally proper to establish such reserves by increasing an existing deficit in earned surplus and thereafter eliminating such deficit against capital surplus?

To cite a few examples: A manufacturing company having considerable silver in its inventories wished to set up a reserve for price declines which might result from the removal of the government market at some time in the future. No claim was made that any such action was believed to be contemplated or that the loss was inherent in the inventory now on hand. Capital surplus was thus in effect to be used to absorb a normal operating

risk of the future. In another case, a mining company's board of directors, following a technical reorganization, appropriated approximately $1,500,000 from capital surplus, one half as a reserve for the investigation and acquisition of mining opportunities and the other half as a reserve for retirement bonus of employees. At first blush both of these reserves looked to us very much like the inventory reserve just mentioned in that they seemed to deal with the future rather than the past. Further investigation as to the reserve for retirement bonus developed the fact that the company's principal mine property was nearly exhausted and that the company when retiring employees because of a decline in operations paid at severance bonuses based upon the employee's years of service. It seemed reasonable to us that a reserve for these payments should have been provided out of past profits and the charge against capital surplus was allowed to stand.

As for the reserve for investigation and acquisition of mining opportunities, the company's accountant argued that such activities were outside the usual and ordinary activities of the company and that therefore, since the directors had made specific provision for them, expenditures in furtherance of these purposes should be properly charged against the reserves and not against the operations of the future years. Expenditures such as these, however, seem to have little bearing on the past, but, on the contrary, seem to represent a hopeful view of the future, and if the results prove disappointing, represent a loss attributable to the future.

As a fourth step in the procedure, it seems essential that earned surplus be exhausted. A somewhat unusual variation of this problem was discovered in material filed by an investment company. The company had a small earned surplus balance when the directors asked the stockholders to approve a reduction in the stated value of the stock to create a capital surplus to be designated "Reserve for Possible Losses on Sales of Securities." In connection with this change the company proposed to adopt the practice of segregating gains and losses on security sales from income from interest and dividends. Since organization of the company over ten years earlier, however, both were included in the income statement and carried to a single earned surplus account. It was now proposed to apply the new principle to all prior years by transferring from the reserve created from capital surplus to earned surplus a sum equal to the net losses of all prior years which had been charged in those years to earned surplus. On this point the Commission, in reviewing the proposal, concluded that it would not be in accordance with good accounting practice to emerge from a quasi-reorganization with a balance of earned surplus created by transferring security losses of prior years to capital surplus presently created.

In another case a company sought to charge an operating deficit larger than all existing capital surplus to the latter account and describe the resulting balance as "Capital Surplus (Deficit)". Even though this procedure was approved by stockholders, is it possible, within the realm of sound accounting that an operating deficit can thus easily be eliminated or indeed that there can be such a concept as a capital surplus deficit?

I have cited a few examples of problems that arise at the time a technical reorganization is effected. Other difficulties develop in transactions following the reorganization. For example, what is the proper treatment of profit or loss realized on the sale of assets written down or

subsequent recovery of losses recognized in the reorganization? If depreciation is based on written down values must the difference between the old and new charges and the effect on profits be shown? If so, for how long a period? Do special rules apply to marketable securities in case of reduction to the current market value of the moment? Should a corporation after a quasi-reorganization be considered as an entirely new legal entity and these questions decided on that basis or must we continually hark back to the old bases in recording profit or loss upon disposal of revalued assets?

A very simple example of the problem is the case of a recovery of bad debts and balances in closed banks written off at the date of the reorganization. The registrant had credited these items to earned surplus and profit and loss while our examiners of the statements felt that the credits should have been to capital surplus. In this instance after discussion with the registrant's accountant the objection was waived on grounds of immateriality but without actually deciding the principle involved.

A much more important case involving several problems was that of a large investment company holding substantial blocks of stock of several companies. This company restated its capital and wrote down the values of its securities to market, first eliminating earned surplus and charging the balance partly to capital surplus and partly to reserve for investments which had been created from capital surplus. The company in a letter to stockholders advised them that any profits arising from sales of securities at prices in excess of the marked-down values but less than original cost would be credited to capital surplus and that losses based on the marked-down value would be debited to earned surplus.

In that case also certain dividends on the companies' investments had been declared prior to the effective date of the quasi-reorganization but under the company's accounting methods would not be taken up in the accounts until after the effective date when payment was received. Are such dividends income to the reorganized company or are they to be treated as a restoration of capital surplus since, if recorded when declared, the necessary charge to capital surplus would have been reduced?

If investments representing control are held by the reorganized company, a question is raised as to the proper treatment of the surplus of the subsidiaries existing at the date of the quasi-reorganization. In a number of cases on this point we have taken the position that the effective date must be regarded as a date of acquisition of control for the purpose of freezing the surplus of the subsidiaries. To consider dividends from such surplus as a proper credit to the subsequent income and earned surplus of the parent would obviously negative the principle that earned surplus must first be exhausted and would permit the anomaly of a reorganized company immediately obtaining an earned surplus through declaration of dividends by its subsidiaries out of prior earnings. If the carrying value of investments in subsidiaries were not changed in reorganization, it is perhaps arguable that dividends from subsidiaries may be credited to capital surplus rather than as reductions of investment to the extent that such dividends, if received prior to reorganization, would have been considered proper credits to income.

It is generally conceded that after writing off a deficit the new earned surplus should be dated. But the question often arises as to

the appropriate date to be chosen. It seems clear that it would be inequitable to permit a retroactive adjustment as of a date long past since such a procedure would permit through hindsight the choice of the date when losses ceased and earnings began. In addition, the accuracy of all intervening financial statements, correct when filed, would be challenged. On the other hand it hardly seems necessary to require the effective date to be that at which the consent of stockholders was given. As a solution it may be suggested that except under unusual circumstances a date not prior to the close of the most recent fiscal year should be selected. Preferably the date should coincide with the fiscal date in order that the year end statements might be used to establish the starting point and to prevent the need of determining interim profits. It seems also desirable that the necessary corporate action be taken as soon after the date selected as is practicable.

To summarize the examples discussed, I would like to suggest for your consideration certain of the main principles which to my mind should underlie the use of the quasi-reorganization technique. To effect such a procedure it seems to me necessary that (1) earned surplus be exhausted; (2) no deficit remain in any surplus account; (3) subsequent statements of earned surplus designate the point of time from which the new surplus dates; (4) the specific transactions be approved in advance by all classes of persons entitled to vote on matters of corporate policy: (5) assets be not reduced below their "fair" value; (6) the date chosen be as recent as is practicable but not ordinarily prior to the close of the most recent fiscal year; and (7) in the case of affiliated corporations, the effective date be recognized as having the significance of a date of acquisition of control in dealing with dividends from subsidiaries and in classifying surplus on a consolidated balance sheet.

The procedure is new. Many vexing questions are unsettled. Not the least of them is this, may the process be repeated not at all, as often as may be desired, or only under stringent restrictions?

Restoration of Earned Surplus

Another unusual development of the distinction between capital and earned surplus has recently appeared. In a number of recent cases registrants, with the approval of their accountants, have sought to reconsider charges previously and properly made to earned surplus in the light of the subsequent history of the company. It should be conceded, I think, that an erroneous entry may later be corrected. But if a completed transaction is recorded in accordance with accepted accounting principles, is there justification for reconsideration of the entry and subsequent change in treatment? In some cases the changed treatment may have been an acceptable alternative at the time of the original entry. In others, the alternative treatment is acceptable if at all only in the light of subsequent unrelated and unforeseen conditions. Typically, the problem arises in the form of a charge to capital surplus and a concomitant credit to earned surplus. In some cases the capital surplus was present at the time of the original entry. In others, the capital surplus resulted from the sale of original issues or from dealings in treasury stock subsequent to the original entry. Perhaps the problem is merely a simple one of deciding whether there is a statute of limitations which runs against accounting decisions. A recital of some few cases will serve to illustrate the problem.

A registrant included in its balance sheet at the close of the last fiscal year this item:

"Earned surplus (including $4,500,000 which had been capitalized as part of a $5,000,000 stock dividend in 1922 and returned to earned surplus upon reduction of capital stock from $6,000,000 to $1,500,000 in 1933) $5,295,273.45"

Conferences and correspondence brought out that in 1922 a stock dividend of 500% was declared and charged to earned surplus lest a tax be imposed upon the accumulated surplus of corporations. By 1933 earned surplus had dwindled. The company thereupon translated its $100 par stock into an equal number of no par shares with a stated value of $25. To record this exchange it was proposed to debit capital and credit earned surplus in the amount of $4,500,000, thus leaving $500,000 of the previously capitalized earned surplus in the capital stock account.

The registrant and its advisors sought to rationalize this entry on the ground that the $4,500,000 was earned surplus because the effect of a stock dividend followed by a reduction in stated value of the shares was not substantially different from a split up of shares in which case earned surplus would have been left intact. It was also claimed that the stockholders' action in 1933 was not substantially different from the rescission of a dividend pursuant to which no actual distribution of any portion of the company's assets had actually been made. It was thus argued that the two transactions, in this case eleven years apart, should be considered as one since during that period the registrant was a closed corporation and no representations had been made to creditors or to the investing public that the surplus had been permanently capitalized. As a final point the position was taken that since the $4,500,000 in question was derived from earnings and since assets were never distributed to stockholders, it is proper, if not necessary, to reflect this amount at this time as earned surplus and not as capital surplus.

The reasoning is ingenious and inviting but to my mind inconsistent with a sound basis for stating the accounts of a corporation. It is my thought as to this that we should not take a position which permits a corporation to capitalize surplus in one year, with a deliberate purpose in mind, and then many years later, with another purpose in mind after the earlier danger has passed, permit the corporation to rescind its former action and tell stockholders that after all we do have earned surplus even though we have called it capital all these years.

Under the provisions of the applicable form segregation of this amount could not be required since all surplus was carried on one account. However, it was insisted that the designation "earned surplus" be deleted.

Many accountants, as well as business men, in good times have considered it a virtue to charge off patents, trademarks and goodwill against any surplus available, paid-in or earned. More recently, as we have seen, the American Institute of Accountants has taken the position that write-offs against capital surplus must not be used "to relieve the income account of the current or future years of charges which would otherwise require to be made against income." This principle restricts write-offs against capital surplus to intangibles such as goodwill, which convention has held to be not subject to amortization in determining income. While this may be debatable, we may accept it for our present purpose.

A registrant whose financial statements were questioned as this paper was being prepared had charged against earned surplus approximately $1,300,000 to eliminate patents, development and goodwill. At the time the entry was recorded no paid-in surplus existed. Several years later common stock was sold and part of the proceeds credited to paid-in surplus. With paid-in surplus now available, the company resurrected the previous charges of intangibles to earned surplus by transferring a sum from paid-in surplus to earned surplus. The balance left in paid-in surplus after this and other charges was appropriated to reserves for investments in and advances to non-consolidated subsidiary companies.

There are two new aspects of the surplus question raised by this case. The first, is it proper, having charged goodwill against earned surplus when no paid-in surplus existed, to transfer the charge years later when a paid-in surplus arises from a sale of stock? The accountants in the case expressed their views on this question in these words: "*It is proper to restate the classification of surplus whenever an event occurs making it necessary or appropriate;* and the subsequent creation of a capital surplus, raising the contrast between earned surplus and capital surplus, is such an event."

Without considering the question of whether goodwill may be charged against paid-in surplus existing at the time of the write-off, it appears to me that if a corporation has reached a decision to charge off goodwill against earned surplus there can be no justification for a transfer at a later date to paid-in surplus non-existent at the time the original decision was made. It seems unreasonable to me to suppose that the first decision could have been made with a reservation that if a paid-in surplus arose in later years it would be used to absorb the charge. If, under these circumstances, a transfer from paid-in to earned surplus may not be availed of to increase earned surplus, may the corporation resort to a reversal of the entry which charged goodwill to earned surplus? I need not express an opinion on this question for so far as I can recall the question has not as yet been presented to us for consideration.

A second problem, potentially more troublesome than the first, arises from the provision out of paid-in surplus of a reserve for investments and advances to non-consolidated subsidiary companies. This opens up the general question of whether it is ever proper to appropriate paid-in surplus, however created, to provide for losses which when sustained should be charged to profit and loss or earned surplus. In the case under discussion and in a closely similar case, the reserves were to provide for possible losses in investments in a foreign country where foreign business was being seriously harrassed and losses were imminent.

In another annual report a reserve for deferred experimental and development costs was provided out of capital surplus and increased in the following year. In the first year the explanation was given that the reserve was for the write-down of intangibles and "was effected as a general valuation adjustment in the interests of conservatism and does not represent any regular prorate of the elements involved." Further inquiry discloses that heavy experimental and development expenses are a regular feature of this industry and may be considered a normal charge to profit and loss. If amortization is thus avoided, it seems clear that the company's method results in an overstatement of earnings for the years in question and an

understatement of the operating deficit and capital surplus. If the purpose of such reserves is to warn all interested parties that net worth may be impaired to that extent, will not the message be lost if the charge is made against paid-in surplus rather than earned surplus? In other words I believe that the principle under discussion, that "Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst," must be construed to apply to the creation of reserves for possible losses as well as to the absorption of previously unrecognized losses such as were the subject of our accounting release number one.

Time will not permit me to outline other fields such as consolidations in which problems arise almost daily, but I should like to present one further illustration of a particularly ingenious confusion of income and surplus.

The company in question had negotiated a large number of stock subscription contracts under which the subscribers agreed to purchase par value common stock at a premium. Typically this involved a cash payment in excess of salesmen's and broker's commissions and for the balance a note payable in instalments running for as many as fifty months. The stock was issued but held by the company as security for the notes which did not bear interest but contained a clause to the effect that "the dividends on the stock may be retained as the total interest hereon until the principal is paid."

At the time registration was sought a large number of the contracts had been executed and a substantial amount of cash had been received. However, an analysis of the subscription notes receivable showed that the majority were in default, many for several years. Furthermore, the contracts provided than on default any amounts received thereon should be retained by the company as liquidating damages. During a period of six years prior to the company's application, total income reported consisted chiefly of interest on the subscription contracts.

Reduced to simplest terms the company's accounting recorded the subscription by debiting cash and notes receivable and crediting capital stock, deferred premium and paid-in surplus, the latter account being credited with the cash received less commissions. The cash was usually less than the total premium included in the contract price so that the notes were equal to par and the amount credited to deferred premium. As additional amounts were received cash would be debited and notes receivable credited and at the same time a corresponding amount would be transferred from deferred premium to paid-in surplus until the total premium had been collected.

Dividends were paid from time to time and debited to paid-in surplus and where the stock was held as collateral on contracts the credit would go to the contract account which would in turn be debited for interest accrued in the amount of the dividend. The balancing entry for the accrued interest was to a profit and loss account "interest on notes." Since a net income resulted from this procedure, this too had the appearance of being a source of further dividends and the consequent accruing of interest.

Upon careful consideration of the entries, the underlying question seems to be whether or not this is a revolving device for presenting the

appearance of income. Conservative management would perhaps have dictated the cancellation of the contracts and the forfeiture of the stock. This would have wiped out most of the company's assets and income. If the condition in the note be merely a method of preventing dividends until the stock had been fully paid, would not sound accounting at least require a direct offset of the interest and dividends so as to reflect clearly the operations of the business? As presented, the device at best would seem to be founded on a principle that dividends on treasury stock are income. But this I believe is conceded on all sides to be in direct contravention of sound accounting principles.

The cases which I have sketched should not be thought of as unusual, but rather as particular variations of recurrent themes. The body of accounting principles which is emerging through your efforts and those of other professional bodies must be tested by application to cases as they arise. This testing process is peculiarly within your province.

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