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GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AS
THEY APPLY TO EQUITY TRANSACTIONS AND
EQUITY PRESENTATION ON THE
BALANCE SHEET

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by

David A. Dietzler

B. S. in Business Administration
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An Independent Study

Submitted to the Faculty

of the

University of North Dakota

in partial fulfillment of the requirements

for the Degree of

Master of Science

Grand Forks, North Dakota

June
1968

This Independent Study submitted by David A. Dietzler in partial fulfillment of the requirements for the Degree of Master of Science from the University of North Dakota is hereby approved by the Faculty Advisory Committee under whom the work has been done.

(Chairman)

Dean of the Graduate School

Permission

Title GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AS THEY APPLY TO EQUITY TRANSACTIONS AND EQUITY PRESENTATION ON THE BALANCE SHEET

Department Accounting

Degree Master of Science

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Signature David A. Dietzler

Date May 21, 1968

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ABSTRACT

The purpose of this study was to determine the generally accepted accounting principles and their sources as they apply to stockholders' equity transactions and their presentation on the balance sheet.

The method used was to study and analyze the authoritative sources of generally accepted accounting principles.

The study revealed that there is no single source, nor is there complete agreement on generally accepted accounting principles. It was concluded that there are several generally accepted sources of accounting principles which include practices commonly found in business, requirements of stock exchanges, requirements of regulatory commissions, Securities and Exchange Commission requirements, opinions of practicing and academic certified public accountants, and published opinions of the American Accounting Association and the American Institute of Certified Public Accountants.

Included in this study are the generally accepted accounting principles as they apply to legal contributed capital, additional contributed capital and retained earnings. It was concluded that in many cases there is more than one acceptable method of recording and presenting the stockholders' equity items included in this study.

CHAPTER I

INTRODUCTION

Generally accepted accounting principles are the basis for almost all of the current textbook material on accounting. These principles are a very important aspect of every Certified Public Accountant's audit and their existence or nonexistence is mentioned in almost every certificate issued by a member of the American Institute of Certified Public Accountants (AICPA) as well as in certificates issued by other CPA's. Much has been written during this century on generally accepted accounting principles. But to this date, nowhere can there be found a standard authoritative list of generally accepted accounting principles. The fact that this has been a problem for some time is indicated by the following three statements:

> After a quarter of a century and more of active discussion and experimentation in this country, many of the simplest and most fundamental problems of accounting remain without an accepted solution. There is still no authoritative statement of essential principles available on which accounting records and statements may be based. Public accountants have been asked to certify to the correctness and adequacy of accounting statements when no satisfactory criteria of correctness and adequacy have been agreed to.[1]

> . . . it is important that we examine critically into the reasons why corporate financial statements of today meet with such cynicism and distrust. What is wrong with accounting as the public sees it? Could it be the fact that there is still no broad authoritative code of accounting principles? Could

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[1] American Accounting Association, "A Statement of Objective of the American Accounting Association," Accounting Review, March, 1936, p. 1.

it be that the two principal accounting organizations take opposite positions on many basic issues? Could it be that there is no standardization of terminology and that many of the terms of accounting are technical jargon which the layman doesn't understand? Could it be that there are still no fixed standards of minimum disclosure for financial statements? Could it be that there is a great variety of form and content in financial statements, making it difficult to compare one company with another? Could it be that there is still a great range of accounting practice and that many identical transactions are treated in different ways in different companies? Could it be that the chief criterion of accounting procedures is their general acceptance which is a passive concept in which the acceptance is by the creators of the practices and not by the reader?[1]

The opinion paragraph of the standard form of certificate uniformly reads that the financial position and operating results are fairly presented 'in accordance with generally accepted accounting principles.' While practically every accounting firm uses this standard wording to express its opinion on corporate financial statements, there is no general agreement as to the exact meaning of the phrase or its applicability to the variety of situations in which it is used.[2]

Even though these three statements deal with the same problem, they were written many years apart. The first statement was written in 1936, the second in 1949, and the third in 1958. This is not to say that progress in the area of formulating generally accepted accounting principles has not taken place over this period of time. Much has been written in this area and many accounting principles have evolved during this period. The problem in the area of generally accepted accounting principles today is not so much the absence of accounting principles as it was in the early part of this century, but one of

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[1]Maurice Stans, "Accounting Weaknesses Which Inhibit Understanding of Free Enterprise," Journal of Accountancy, December, 1949, pp. 468-69.

[2]Leonard Spacek, "Challenges to Public Accounting," Harvard Business Review, May-June, 1958, p. 116.

determining which of several acceptable principles is best in a given situation.

The phrase generally accepted accounting principles has been defined by the accounting organizations as well as by several prominent professional accountants. The AICPA defines a principle as follows: "In accounting, a principle is a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice."[1] Walter Kell, former president of the American Accounting Association (AAA) adds to this definition of principles in a recent article of his when he wrote the following: "As applied to accounting practice, principles represent broad general guidelines for action rather than inflexible rules from which there can be no deviation."[2]

In accounting the expression "generally accepted" has a specific meaning which varies from the normal meaning of these words. This difference is pointed out by Kell:

> The expression "generally accepted" is particularly troublesome for the accounting interpretation is at variance with popular meanings. The term "general" does not mean a majority; it does not even connote prevalent. In accounting, "generally accepted" means that there is some substantial authoritative support for the principle.[3]

When Kell mentions substantial authoritative support he is referring to the various sources of accounting principles.

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[1] American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (New York: American Institute of Certified Public Accountants, 1965), pp. 52-53.

[2] Walter G. Kell, "The Auditor's Responsibilities in Financial Reporting," Michigan Business Review, March, 1967, p. 27.

[3] Ibid.

Paul Grady outlines and elaborates on the sources for determining whether an accounting practice has substantial authoritative support. These have been considered the sources for many years and they are:

> (1) In the practices commonly found in business. This does not follow from the mere fact that a practice exists, but from the fact that experience of the business has demonstrated that the practice produces dependable results for the guidance of management and for the information of investors and others.
>
> (2) The requirements and views of stock exchanges as leaders in the financial community; similarly the views and opinions of commercial and investment bankers would be entitled to weight.
>
> (3) The regulatory commissions' uniform systems of accounts and accounting rulings exercise a dominant influence on the accounting practices of the industries subject to their jurisdiction. The commissions sometimes depart from generally accepted accounting principles and, in such cases, it may be necessary for the certified public accountant to make appropriate qualifications in his report.
>
> (4) The regulations and accounting opinions of the Securities and Exchange Commission have the controlling authority over reports filed with the Commission. The Commission and its chief accountants have demonstrated a high degree of objectivity, restraint and expertness in dealing with accounting matters. The regulations and opinions issued to date are entitled to acceptance by their merit as well as on the basis of the statutory authority of the Commission.
>
> (5) The affirmative opinions of practicing and academic certified public accountants constitute authoritative support for accounting principles or practices. These may be found in oral or written opinions, expert testimony, textbooks and articles.
>
> (6) Published opinions by committees of the American Accounting Association and of the American Institute of Certified Public Accountants.[1]

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[1]Paul Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises, Accounting Research Study No. 7 (New York: American Institute of Certified Public Accountants, 1965), pp. 52-53.

In 1959, the AICPA established the Accounting Principles Board (APB) in an effort to limit the areas of differences which exist in accounting practice and to promote greater uniformity and comparability in financial reporting. The APB has the authority to issue pronouncements on accounting principles, and the opinions of the APB are expected to be regarded as authoritative written expressions of generally accepted accounting principles.[1] Since its beginning, the APB has issued twelve opinions with more sure to come.

Although the Securities and Exchange Commission (SEC) has the authority to prescribe the accounting principles to be followed in financial statements filed with it, the commission has not, with certain exceptions, involved its authority to dictate how financial statements shall be prepared. In regulation S-X it listed its requirement as to form and content of financial statements filed under the SEC rules and regulations. In its decisions and in the Accounting Series Releases, it has stated its opinion concerning a few accounting principles. For the greater part, the accounting principles that are the basis for the preparation of financial statements under SEC rules have been developed by outside sources over a period of time. Many problems would arise if the business would follow one set of accounting principles for filing with the SEC and another set for other purposes. However, the SEC could exercise more authority in the area of required accounting principles if it chose to do so. This statement is supported by a portion of a speech made by a commissioner when he said:

> . . . The commission has exercised sweeping powers with considerable restraint. The commission's philosophy in this

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[1] *Ibid.*

> regard was set forth in its Accounting Release No. 4, dated April 25, 1938, and it has not changed in 25 years. A reliance upon 'generally accepted accounting principles' as developed by the accounting profession has left a great deal of room for variation in the accounting practices and principles observed by companies whether or not they are subject to the requirements of the commission. The unanswered question presented by this history . . . is whether the commission's restraint has been and continues to be in the public interest and in the interest of investors. Do the disclosures of accounting principles followed, as contained in the prospective, really make it possible for an analyst to make a side by side comparison of two competing companies' earning statements? I doubt it. I do not suggest that unvarying application of uniform accounting principles is a desirable end in itself. I don't like strait jackets. However, we may not have gone as far in that direction as we should.[1]

So it's very possible that in the future the SEC may play a greater part in the initiation and development of generally accepted accounting principles.

The formal opinions of the APB and its predecessor committee carry the greatest weight with members of the AICPA in their determination of generally accepted accounting principles. The committee in the introduction to Accounting Research Bulletin No. 43, made the comments contained in the five succeeding paragraphs regarding the applicability and authority of its opinions.

> (11) Underlying all committee opinions is the fact that the accounts of a company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statements and to state clearly such explanations, amplifications, disagreements, or disapproval as he deems appropriate. While opinions of the committee are addressed particularly to certified public accountants whose problem it is to decide what they may properly report, the committee recommends similar application of the procedures mentioned herein by those who prepare the accounts and financial statements.

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[1]Louis H. Rappaport, SEC Accounting Practice and Procedure (2d ed., rev.; New York: The Ronald Press Company, 1966), p. 3·2.

(5) The principal objective of the committee has been to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted accounting principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies. In this endeavor, the committee has considered the interpretation and application of such principles as appeared to it to be pertinent to particular accounting problems or procedures of religious, charitable, scientific, educational, and similar nonprofit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

(8) Except in cases in which formal adaption by the institute membership has been asked and secured, the authority of opinions reached by the committee rests upon their general acceptability. The committee recognizes that in extraordinary cases fair presentation and justice to all parties at interest may require exceptional treatment. But the burden of justifying departure from accepted procedures, to the extent that they are evidenced in committee opinions must be assumed by those who adopt another treatment.

(9) The committee contemplates that its opinions will have application only to items material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest. However, freedom to deal expediently with immaterial items should not extend to a group of items whose cumulative effect in any one financial statement may be material and significant.

(10) No opinion issued by the committee is intended to have a retroactive effect unless it contains a statement of such intention. Thus an opinion will ordinarily have no application to a transaction arising prior to its publication, nor to transactions in process of completion at the time of publication. But while the committee considers it inequitable to make its statements retroactive, it does not wish to discourage the revision of past accounts in an individual case if it appears to be desirable in the circumstances.[1]

The road to the development of accounting principles has been rocky and very slow at times. Fortunately this sluggishness has not

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[1] Accounting Research and Terminology Bulletins, pp. 28-32.

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The road to the development of accounting principles has been rocky and very slow at times. Fortunately this sluggishness has not

[1] _Accounting Research and Terminology Bulletins_, pp. 28-32.

deterred various groups and individuals from attempting to codify and establish principles of accounting. The goal of these efforts has been to narrow the areas of difference and inconsistencies in the accounting process and thereby to attain more credibility and acceptability for monetary representations on financial statements. The efforts for the past years have been concentrated on the terminology and practices followed in commercial and industrial income-seeking business units; but an increasing amount of attention has been devoted to the needs of governmental and other organizations.

What is happening in the area of generally accepted accounting principles is a never-ending search for better and more refined methods of reporting the facts about financial affairs of corporations. But as the business affairs grow more and more complex, the facts are not clear and simple. In this search for improved methods there are bound to be differences of opinion as to which method among many alternatives, all supportable in theory and logic, would give the most useful results to those concerned. Time and experience reveal which method is superior. The superior method eventually becomes generally adopted. Meanwhile, however, there are going to be variations in practice.

The following pages of this paper are intended to bring out the accounting principles deemed to have reached accepted status in the area of stockholders' equity transactions and their balance sheet presentations.

CHAPTER II

CONTRIBUTED CAPITAL

Before getting into a discussion of the various equity items a review of terminology in this area should be given. For many years the term "surplus" was used in association with equity items.

In 1941, the AICPA suggested a general discontinuance of the use of the term surplus. They suggested that a substitution should be made that would emphasize the distinction between: (a) legal capital, (b) capital in excess of legal capital, and (c) undivided profit.[1]

Prior to 1941, the terms capital surplus and earned surplus had been widely used. However, the use of these terms was open to serious objections. The use of the term surplus has a connotation of excess, overplus, or residue; whereas, no such meaning is intended where the term is used in accounting. Also, this term has an established meaning in other fields such as economics and law, which is not in accordance with the meaning the accountant seeks to convey. In seeking terms more nearly connotative of the ideas sought to be expressed, the AICPA in 1949 gave primary consideration to sources from which the proprietary capital was derived.

They recommended that the use of the term surplus in such combinations as capital surplus, earned surplus, appraisal surplus, and any other combination be discontinued. The AICPA also recommended that

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[1] Accounting Research and Terminology Bulletins, p. 28.

the contributed portion of proprietary capital be separated into three categories. The first category should include the par or stated value of each class of shares outstanding. The second category should include the excess over par or stated value from original issue or from reissuance of a corporation's own stock. The third category should be composed of capital received other than for shares whether from shareholders or from others. Another terminology change recommended by the AICPA in 1949 suggested that the term earned surplus be replaced by terms indicating source, such as retained income or retained earnings. In the case of a deficit, the amount should be shown as a deduction from contributed capital with the appropriate description.[1]

The preceding recommendations of the AICPA have been increasingly followed by practicing accountants. According to a study made of numerous published corporate financial statements by the AICPA, the proportion of such statements in which the term surplus was not used was 10 per cent for 1947 and 18 per cent for 1948; but for 1949, 1950, and 1951, after the recommendation was published, it was 32 per cent, 41 per cent, and 44 per cent, respectively.[2]

The trend in the discontinuance of the surplus terms has continued. In 1966, 66 per cent of the 600 companies included in the survey had replaced the term surplus for "capital" type accounts and

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[1] Ibid., p. 31.

[2] Ibid., p. 32.

83 per cent had replaced the term surplus in reference to the retained earnings account.[1]

Contributed capital should be subdivided between legal or stated capital and additional items. Legal capital consists of the par or stated value of shares and any amount received for pure no par stock. Additional contributed capital items consist of such amounts as premium on par value stock, excess of amount received over stated value of stock, excess of capital from sale of treasury stock and the like.

The following summary of the stockholders' equity section of the balance sheet will illustrate contributed capital presentation as well as proper presentation of retained earnings.

STOCKHOLDERS' EQUITY[2]

Contributed Capital:
Capital Stock:
Preferred stock - 5% cumulative; par value $100; authorized _____ shares; issued _____ shares ....
Class A preferred stock - $3.00 cumulative; no par value, redeemable value $30; authorized and issued _____ shares ....
Common stock - no par value; stated value $10; authorized _____ shares; issued _____ shares of which _____ are in the treasury ....

Capital Paid-in in Excess of Par, Redemption and Stated Values of Capital Stocks:
Premium on preferred stock ....

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[1]American Institute of Certified Public Accountants, Accounting Trends and Techniques (New York: American Institute of Certified Public Accountants, 1966), p. 16.

[2]Grady, Inventory of Generally Accepted Accounting Principles, p. 192.

Arising from treasury stock transactions	....	
Paid-in on common stock	....	....
Retained Earnings:		
Appropriated in amount equal to restriction under bank loan as to payment of dividends	....	
Unappropriated	....	....
Total		....
Deduct Cost of _____ Shares of Treasury Common Stock		....
Stockholder Equity		....

The balance sheet should show the amount of capital stock authorized as well as issued. The fact that the company is or is not authorized to issue additional stock is of some significance to the stockholders. None of the 600 balance sheets for 1966 which were examined failed to state the amount of capital stock authorized. Twelve of the balance sheets examined in 1950 and six of those examined in 1960 failed to state the amount authorized.[1] A few state statutes require a showing of authorized stock in the balance sheet.[2]

As illustrated, where more than one class of stock is issued, each class should be stated separately in the balance sheet. Besides a requirement of the AICPA, a separation of classes of stock is required by statute in California, Massachusetts, and Michigan, as well as by the regulations of the SEC.[3]

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[1] Accounting Trends and Techniques, p. 149.

[2] Thomas Henry Sanders, Henry Hatfield, and Underhill Moore, A Statement of Accounting Principles (United States: American Accounting Association, 1959), p. 85.

[3] Ibid., p. 86.

Capital paid-in excess of par and other contributed capital are shown in the preceding illustration. This section of stockholders' equity is usually referred to as additional paid-in capital. Although many companies report on the balance sheet a single value for additional paid-in capital, separate accounts should be provided in the ledger to identify the individual sources of such capital. Sources of additional paid-in capital and accounts summarizing these include the following:

A. Paid-in capital resulting from transactions in the company's own stock:

   1. Premiums on par value stock.

   2. Excess of amounts received for non-par stock over amounts set up as stated values thereof.

   3. Forfeited part payments on stock subscriptions.

   4. Paid-in capital resulting from miscellaneous stock transactions and changes:

      a. Reissuance of treasury stock at more than the amount at which it is carried in the accounts.

      b. Retirement of stock by an expenditure less than the amount set up as stated capital.

      c. Conversion of stock of one kind into a smaller amount of stock of another kind.

      d. Reduction of stated capital.

B. Paid-in capital resulting from stockholders' contributions:

   1. Donations by stockholders, including gifts and forgiveness of indebtedness.

   2. Assessments on stockholders.

C. Paid-in capital resulting from contributions by outsiders, including gifts of assets (such as a plant given to induce a company to locate in the donor city) and forgiveness of indebtedness.

D. Paid-in capital resulting from distributions of stock dividends and similar actions ordered by the board of directors by which some portion of retained earnings is reclassified as part of the capital of the corporation and thus credited to the capital stock and paid-in capital accounts.[1]

Although all of these elements may be regarded as paid-in capital, they should not all be recorded in a single paid-in capital account. One reason for keeping separate accounts with the various elements of paid-in capital is that certain elements of paid-in capital may be available for dividends, whereas other elements are not. Also, certain other charges can properly be made to paid-in capital. For example, paid-in capital resulting from the issuance of stock at a premium can properly be charged with a premium paid on the retirement of stock of the same class. But, if preferred stock is issued at par and common stock is issued at a premium of, say $30,000, and if the preferred stock is subsequently retired at a premium of $10,000, the SEC refuses to sanction charging the premium on retirement of the preferred stock against the paid-in capital resulting from the issuance of the common stock at a premium. Most accountants agree with the SEC on this matter.[2]

As noted earlier, the AICPA has defined paid-in capital as follows:

> Capital contributed for, assigned to, shares in excess of par or stated value . . . or of transactions by the corporation

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[1]H. A. Finney and Herbert E. Miller, Principles of Accounting, Intermediate (6th ed., rev.; Englewood Cliffs, New Jersey: Prentice-Hall, Inc.), p. 104.

[2]Ibid., p. 105.

in its own shares; and capital received other than for shares, whether from shareholders or from others.[1]

The AAA has defined paid-in capital as follows:

> Paid-in capital is measured by the cash, or fair market value of other assets or services, contributed by stockholders or by persons acting in a capacity other than that of stockholders or creditors, or by the amount of liabilities discharged upon the transfer of an equity from a creditor to a stockholder status. Paid-in capital may be reduced by the redemption or other reduction of outstanding shares, payments of liquidating dividends, or adjustments effected by a corporate reorganization
>
> The reduction of paid-in capital upon the contraction of outstanding shares may not exceed the pro ratio portion of paid-in capital applicable to the number of shares contracted.[2]

In some states, it is legal to sell an original issue of capital stock at a price below its par value.[3] This type of transaction is not common, because purchasers of capital stock at a price below par are usually liable (to corporate creditors) for the discount in the event the company becomes insolvent. In accounting for capital stock, the objective is to reflect in the accounts the amount invested by stockholders in the corporation. Therefore, the discount on the capital stock account should be deducted from the capital stock account in the balance sheet so as to present the net proceeds from the sale of stock. The discount or capital stock account is a valuation account;

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[1] Accounting Research and Terminology Bulletins, p. 30.

[2] American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Iowa City: American Accounting Association), p. 7.

[3] Arnold W. Johnson and Oscar M. Kriegman, Intermediate Accounting (3rd ed., rev.; New York: Holt, Rinehart & Winston), p. 416.

it is not a loss, no asset has been sold and no shrinkage has occurred in the book value of the net assets of the affected corporation.[1]

The SEC believes that a discount on capital stock should be shown separately as a deduction from capital shares.[2]

One of the functions of accounting is that of distinguishing between the current amount of corporate net worth and the amount of capital originally invested in the corporation. For this reason, the discount on the capital stock account should remain on the books as a permanent negative element of net worth or until it is extinguished by cash or other consideration received in discharge of the discount.[3]

When the amount received on the sale of stock is greater than the par or stated value assigned to the stock the excess is recorded separately and is carried on the books as long as the stock to which it relates is outstanding. When stock is retired, cancellation of the capital stock balance, as well as any related paid-in capital balance is considered proper.

Accounting for no-par stock is somewhat different than accounting for stock with a par value. The proceeds from the sale of no-par-value capital stock (without a stated value) should be credited to the capital stock account. When no-par-value stock has a stated value (per charter) or when its stated value has been fixed by an official act of a given company's board of directors, the proceeds of the sale may be apportioned between the capital stock account and an

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[1] Ibid.

[2] Rappaport, SEC Accounting Practice and Procedure, p. 14·17.

[3] Johnson and Kriegman, Intermediate Accounting, p. 416.

account such as paid-in capital from the sale of capital stock. The stated value of the stock would be credited to the capital stock account, the remainder to the paid-in capital account. It should be mentioned that some states, by law, specify the minimum amount that can be designated as stated value per share.[1]

Another source of paid-in capital results from uncollectible subscriptions to capital stock. If a subscription to capital stock cannot be collected, the entries related to the forfeiture must comply with the statutory requirements of a company's state of incorporation. In some states, the payments made by a defaulting subscriber are forfeited in favor of the corporation. If this is the case, the payments are credited to a paid-in surplus account.[2]

Paid-in capital from the sale of treasury stock was previously listed as a source of additional paid-in capital. Before discussing how this item of paid-in capital arises, a discussion of treasury stock transactions will be given. There are two general approaches to the purchase of treasury stock. The acquisition of treasury stock may be viewed as the retirement of outstanding stock. The other method is that the acquisition of treasury stock may be viewed as giving rise to a capital element whose ultimate disposition still remains to be resolved.[3]

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[1] _Ibid._, p. 417.

[2] _Ibid._, p. 419.

[3] Harry Simons and Wilbert E. Karrenbrock, _Intermediate Accounting_ (4th ed., rev.; Chicago: South-Western Publishing Company, 1964), p. 613.

The AAA Committee on Concepts and Standards Underlying Corporate Financial Statements views the acquisition of treasury stock as the retirement of outstanding stock. The committee has commented:

> The acquisition of its own shares by a corporation represents a contraction of its capital structure. However, statutory requirements are particularly restrictive in this area of corporate activity and, to an important degree, are controlling in the reporting of such transactions. Preferably, the outlay by a corporation for its own shares is reflected as a reduction of the aggregate of contributed capital, and any excess of outlay over the pro-rata portion of contributed capital as a distribution of retained earnings. The issuance of reacquired shares should be accounted for in the same way as the issuance of previously unissued shares; that is, the entire proceeds should be credited to contributed capital.[1]

A special committee of the AICPA, in answering questions raised by the New York Stock Exchange relating to the accounting treatment of the purchase and resale by a corporation of its own common stock, took a similar view. It concluded:

> . . . Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock.[2]

When the reacquisition of stock is viewed as stock retirement, alternative methods may be employed in reporting the reduction of capital stock. The capital stock account may be directly reduced, or a treasury stock account may be charged and deducted from the capital stock account on the balance sheet.[3]

If treasury stock acquisition is viewed as giving rise to a capital element awaiting ultimate disposition, the purchase price should

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[1] Accounting and Reporting Standards, p. 7.

[2] Accounting Research and Terminology Bulletins, p. 14.

[3] Simons and Karrenbrock, Intermediate Accounting, p. 613.

be charged to a treasury stock account.[1] This balance is recognized as a negative capital element that does not call for specific identification with paid-in capital or retained earnings. This is the method presumed to have been followed in the illustration of treasury stock in the stockholders' equity section presented earlier in this paper.

If treasury stock is sold at more than cost under the second method, the excess gives rise to paid-in capital arising from treasury stock transactions. If the treasury stock were sold at less than cost, the loss would be chargeable to retained earnings. If the stock was reacquired by donation (issued fully paid and nonassessable) and later sold, the entire receipt of the sale becomes invested capital attributable to the resold shares.[2]

According to the SEC, treasury shares must be shown separately as a deduction from capital shares or from the total of contributed capital and retained earnings or from retained earnings. They state that shares must be deducted at either par, stated value, or cost, as circumstances require.[3]

At times treasury stock is shown as an asset. Most accountants and the SEC agree that treating treasury stock as an asset is proper only if its corporation reacquired the outstanding stock for distribution to officers or employees pursuant to a bonus or stock purchase plan.[4]

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[1] Ibid., p. 615.

[2] Grady, Inventory of Generally Accepted Accounting Principles, p. 202.

[3] Rappaport, SEC Accounting Practice and Procedure, p. 14·18.

[4] Ibid.

Out of 600 balance sheets examined in 1965, 377 contained items of reacquired shares. Sixty-six per cent of the 377 balance sheets showed treasury stock as a deduction from the sum of contributed capital and retained earnings. Twenty-three per cent showed treasury stock as a deduction from issued stock of the same class.[1]

At times stock is exchanged for a consideration other than cash. When at the time of the exchange, stock is sold by the company for cash or is quoted on the open market at a certain price, that price can be used to record the consideration received and the capital increase. When the cash value of the securities cannot be determined, it is necessary to arrive at a value for the consideration that was acquired.[2]

Laws of some states provide that a corporation requiring additional capital may make an assessment against the stockholders. If stock was originally issued at a discount, an additional capital contribution is recognized as a reduction in the discount; if legal capital requirements were fully met by original investments, assessments should be treated as increases in corporate paid-in capital.[3]

An item of disclosure not previously mentioned is concerned with stock options. Disclosure should be made as to the status of the option or plan at the end of the reporting period, including the number of shares under option, the option price, and the number of shares to which options are exercisable. For the options exercised during the

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[1] Accounting Trends and Techniques, p. 149.

[2] Simons and Karrenbrock, Intermediate Accounting, p. 591.

[3] Ibid., p. 592.

year, disclosure should be made of the number of shares involved and the option price thereof.[1]

A rule adopted by the AICPA in 1934 should be mentioned in closing this chapter. It reads as follows:

> Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fail 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 require 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.[2]

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[1] _Accounting Research and Terminology Bulletins_, p. 124.

[2] _Ibid._, p. 45.

CHAPTER III

RETAINED EARNINGS

According to Grady, retained earnings should represent the cumulative balance of yearly earnings less dividend distributions in cash, property or stock, plus or minus gains and losses of such magnitude as not to be properly included in yearly earnings. The entire amount of retained earnings may be considered to be unrestricted as to dividend distribution unless restrictions are indicated in the financial statement.[1]

Grady's definition of retained earnings is very similar to that of the AICPA, which follows:

> Retained earnings means the balance of net profits, income, gains and losses of a corporation from the date of incorporation (or from the latest date when a deficit was eliminated in a quasi-reorganization) after deducting distributions therefrom to shareholders and transfers therefrom to capital stock or capital surplus accounts.[2]

The AAA has defined retained earnings thus:

> . . . it is the amount of income since the formation or a reorganization of the enterprise less the amount distributed to stockholders. Distributions include dividends and the excess of the amount of assets disbursed in the reacquisition of shares of capital stock over the pro rata portion of paid-in capital applicable to such shares. The distinction between paid-in capital and retained earnings should be permanent. Where retained income has been designated as paid-in capital by means of stock dividends recapitalizations, or by other customary

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[1]Grady, Inventory of Generally Accepted Accounting Principles, p. 202.

[2]Accounting Research and Terminology Bulletins, p. 16.

corporate action, the amount so designated should be indicated in the balance sheet.[1]

As previously mentioned, retained earnings are considered to be unrestricted unless otherwise indicated. Restrictions may be indicated by footnote or parenthetical notation.[2] Restrictions of retained earnings are of three basic types.[3] They may be statutory restrictions which are those required by the laws of the state in which a given company is incorporated. Another type are the contractual restrictions which are those required to be established under the provisions of a contract. Voluntary restrictions are those established at the discretion of a company's board of directors.

The word "reserve" is sometimes used in the retained earnings sections to describe appropriations of retained earnings.[4] The AICPA has recommended that the term "reserve" be limited to an indication of appropriated retained earnings.[5] The AAA believes that the term "reserve" should not be used at all in the balance sheet presentation of assets, liabilities, or stockholders' equity.[6]

Retained earnings can be reduced by the declaration of dividends. When a dividend payable in cash or property has been declared and notice given to the stockholders, the dividend becomes a legal obligation and

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[1]Accounting and Reporting Standards, p. 16.

[2]Grady, Inventory of Generally Accepted Accounting Principles, p. 203.

[3]Johnson and Kriegman, Intermediate Accounting, p. 451.

[4]Ibid., p. 452.

[5]Accounting Research and Terminology Bulletins, p. 27.

[6]Accounting and Reporting Standards, pp. 19-20.

may not be rescinded without the consent of the stockholders. Therefore, retained earnings is charged with the appropriate amount at the time of declaration.[1] When dividends are paid in property, there are two alternatives as to the amount that can be charged to retained earnings. One is that retained earnings be charged with the cost of the property to the corporation giving up the property. The other alternative involves charging retained earnings with the market value of the property at the date the dividend is declared, with any difference between market value and cost charged or credited to income or retained earnings for the period.[2]

Stock dividends and stock splits appear to be similar, but are substantially different and, accordingly, require different accounting treatment. The subject of stock dividends and stock splits is treated in Accounting Research Bulletin No. 43, parts of which are reproduced below:

> (1) The term stock dividend as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.[3]
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> (10) As has been previously stated, a stock dividend does not in fact give rise to any change whatsoever in either the corporation's assets or its respective shareholders' proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed

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[1]Grady, Inventory of Generally Accepted Accounting Principles, pp. 19-20.

[2]Ibid.

[3]Accounting Research and Terminology Bulletins, p. 49.

> purpose of the transaction and its characterization as a dividend in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee, therefore, believes that where these circumstances exist the corporation should in the public interest, account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.[1]

The Committee on Accounting Procedure described a small stock dividend as being of 20 to 25 per cent of the previously outstanding shares.[2]

Although a small stock dividend may have little or no effect on the market price of a company's shares, a large dividend normally does. Consequently, the Committee on Accounting Procedure has said in regard to a large stock dividend:

> Where the number of additional shares issued as a stock dividend is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share market value, the committee believes that the implications and possible constructions discussed in the preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature of a stock split-up. . . . Consequently, the committee considers that under such circumstances there is no need to capitalize. . . . retained

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[1] *Ibid.*, p. 51.

[2] *Ibid.*, p. 52.

earnings, other than to the extent occasioned by legal requirements.[1]

A stock split has no effect on total stockholders' equity, or on the balances of any of the contributed capital or retained earnings accounts.

In certain circumstances retained earnings are required to be dated. Any earnings after a corporate quasi-reorganization should be separately summarized and reported on the balance sheet as retained earnings dating from the time of such action. In 1956, the AICPA recommended that dating of retained earnings would rarely, if ever, be of significance after a period of ten years and under exceptional circumstances might be discontinued upon conclusion of a shorter period.[2]

The Chief Accountant of the SEC has stated that when a deficit is charged to paid-in capital in the course of a quasi-reorganization, full disclosure of the point of time from which the new retained earnings and until such time as the results of operations of the company on the new basis are available for an appropriate number of years (at least three), any statement or showing of retained earnings should disclose the total amount of the deficit and any charges that were made to paid-in capital which would otherwise have been required to be made against income or retained earnings.[3]

When a company is permitted by state law to charge a deficit to paid-in capital pursuant to a resolution by the board of directors

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[1] Ibid.

[2] Ibid., p. 11.

[3] Simons, and Karrenbrock, Intermediate Accounting, p. 645.

and without approval of the stockholders, the SEC requires complete disclosure of all of the attendant facts and circumstances and their effect on the company's financial position in each balance sheet and surplus statement.[1]

When a depreciable asset is increased as a result of appraisal and when depreciation is reported on the basis of appraised value, transfers may be made periodically from appraisal capital balances to retained earnings. In applying this practice, appraisal capital reports no more than the appraised increase still included in the net asset balance while retained earnings is raised by the amount of the appraisal increase that has been realized. When the asset is fully depreciated, the total amount of the appraisal capital will have been transferred to retained earnings. Appraisal capital, representing unrealized earnings, is not properly used as a basis for cash dividends, however, its use as a basis for stock dividends is allowed in some states.[2]

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[1] Rappaport, SEC Accounting Practice and Procedure, p. 3·30.

[2] Simons and Karrenbrock, Intermediate Accounting, p. 656.

CHAPTER IV

SUMMARY AND CONCLUSIONS

Generally accepted accounting principles are the basis for most accounting practice. It is true that nowhere can there be found an all-inclusive list of these principles. They must be sought in accounts and financial statements, and in other evidences of professional opinion. It is true that they have not been adopted by vote of the profession. But that they have been accepted is evidenced by the common ways of thought and speech which make communication in accounting matters possible, by the generally uniform practice of all accountants when dealing with some situations, by general agreement that, among all the possible ways of dealing with other situations, only a few are proper. So fully is the existence of a body of generally accepted accounting principles recognized that members of the American Institute of Certified Public Accountants and other Certified Public Accountants state in their reports whether generally accepted accounting principles have or have not been followed.

The existence of a body of generally accepted accounting principles does not mean that there is only one proper accounting treatment for every situation with which the accountant must deal. For many situations, there are available a number of treatments which are in accord with the generally accepted principles.

The American Institute of Certified Public Accountants, particularly through its Accounting Principles Board has spoken for the public accounting profession in the area of generally accepted accounting principles. The American Accounting Association has also published information on generally accepted accounting principles. The Securities and Exchange Commission has issued its accounting regulations for the administration of the legislation for which it is responsible. The Bureau of Internal Revenue, through its accounting rules for the determination of taxable income, has contributed to the formulation of accounting principles. Regulatory commissions are from time to time issuing new systems of accounts, or revisions of old systems which affect accounting principles.

The terminology formally used to describe items included in stockholders' equity has undergone some change in the past years. Use of the terms capital surplus and earned surplus are giving way to the more descriptive terms such as contributed capital, paid-in capital, and retained earnings. Contributed capital should be subdivided between legal or stated capital and additional capital.

Legal or stated capital should be separately stated in the stockholders' equity section in the balance sheet. Along with this separation, the amount of authorized stock should be shown. Additional paid-in capital should include such things as premiums on common stock, forfeited part payments on stock subscriptions, paid-in capital from treasury stock transactions, paid-in capital from stockholders' contributions, paid-in capital from contributions by outsiders, and paid-in capital from distributions of stock dividends.

Retained earnings should include the balance of net profit and gains or losses of a corporation from the date of incorporation less distribution to stockholders and transfers to contributed capital since that date. An exception arises in the case of a quasi-reorganization. In this situation, retained earnings would represent the net amount of the above listed additions and deductions from the date of the quasi-reorganization.

Retained earnings are considered to be unappropriated unless otherwise indicated. Restrictions on retained earnings may be required by law or by contract, or they may be voluntary. A restriction of retained earnings can be indicated by footnote or parenthetical notation. The American Institute of Certified Public Accountants would allow the term "reserve" to be used to indicate restricted retained earnings, whereas the American Accounting Association believes that this term should not be used. The American Accounting Association would substitute a term such as "appropriated" to indicate the restriction.

The amount charged to retained earnings when a stock dividend is declared depends on the size of the stock dividend in relation to the total stock of that class outstanding. A stock split on the other hand does not affect the retained earnings balance.

As mentioned earlier in this writing, what is happening in the area of generally accepted accounting principles is a never-ending search for better and more refined methods of reporting the facts about the financial affairs of corporations. But as the business affairs grow more and more complex, the facts are not clear and simple. In this search for improved methods, there are bound to be differences of opinion as to which method among many alternatives would give the most

useful results to those concerned. Therefore, there are bound to be variations in practice.

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