ABSTRACT

AN EVALUATION OF THE ACCOUNTING PROVISIONS IN THE COMPANIES ACT, CANADA, AND THE CORPORATIONS ACT, ONTARIO

by Michael Zin

Among the primary purposes of incorporation law is to provide a basis for an equitable maintenance of the rights of those who may have financial dealings with corporations.

With the growth of corporate enterprise there has been an emergence of a "corporate management group" and a tendency for these professional managers to perpetuate control of enterprise. Thus, the immediate management group of a corporate unit may be a very small minority of corporate share ownership. This delegation of administration demands thorough reporting by management of its stewardship of the assets entrusted to its care to preserve the rights of creditors and owners.

This dissertation studies the problem of inadequate disclosure of corporate financial activity by companies incorporated under the Companies Act, Canada, and the Corporations Act, Ontario.

Corporations are creatures of the state. The state, therefore, has a responsibility to protect those who have, or may have, financial dealings with corporations. One way of attaining protection is through adequate disclosure of corporate financial activity. The Companies Act, Canada, and the Corporations

Act, Ontario, contain certain provisions, compliance with which would purportedly furnish the desired degree of disclosure. Adequate disclosure, however, is not forthcoming in many cases. For example:

A. The statutes do not clearly recognize the distinction between invested capital and reinvested earnings. In failing to distinguish between the sources of ownership equity, the statutes permit financial practices which may be misleading. The following are illustrative of these practices:

   1. "Surpluses," other than retained earnings, can be recorded on the books and may be utilized improperly to eliminate accumulated operating deficits.

   2. Corporate distributions to shareholders may be made under the guise of dividends (division of earnings), while there is an accumulated operating deficit.

   3. "Surplus" accounts can be recorded on the books initially to give an impression of profitability which has not been proven and may not exist.

B. Both the Federal and Ontario Acts permit the misstatement of assets and liabilities which result in future misstatement of periodic income. For example, bond premiums and bond discounts can be written off at the time of bond issuance.

C. The provisions of the statutes are inflexible; they become outdated and do not provide for adequate disclosure of essential financial information arising out of new developments in business finance.

An example is the accounting for long-term leases.

The purpose of this study is to determine the accounting statute revisions, compliance with which would eliminate inadequate disclosure of essential corporate financial activity. The criteria for the evaluation of the statute provisions must cover the interests of both suppliers of capital and the general public. Sufficient financial information must be disclosed so that those who deal with corporations can rely with confidence upon representations in financial statements. The criterion for evaluation of each proposed provision is: does it provide an adequate degree of disclosure to protect the public?

The study is limited to the Companies Act, Canada, and the Corporations Act, Ontario. The relevant statute provisions considered are those with significant accounting implications. Specifically, the statute provisions examined are those which pertain to: (1) Capital of the Corporation, (2) The Corporate Surplus, (3) Corporate Distributions to Shareholders, (4) Corporate Combinations, and (5) Disclosure of Corporate Activity.

The following proposals are recommended to be embodied in the incorporation statutes:

1. (a) Stated capital of the corporation should represent the cost (fair value) of all assets received for the benefit of shareholders, other than the reinvested earnings which have not been "capitalized." Thus the stated capital of the corporation would be equal to the total of: the consideration for share issues, the fair value of donations, and the capitalized retained earnings.

(b) Where a company has more than one class of shares outstanding, the stated capital attributable to each class should be the total consideration received for the outstanding shares of the class.

2. Transfers from retained earnings should be permitted only to stated capital. Transfers which are appropriations of retained earnings should be prohibited.

3. Reduction of stated capital should be permitted where approval is obtained from the creditors and shareholders.

4. The corporate surplus should represent the balance of accumulated net earnings reinvested in the enterprise. The elimination of deficits should be accomplished through future profitable operation or through formal reductions of stated capital equal to the deficit.

5. Corporate distributions of assets to shareholders should be identified as to their nature. Distribution of assets representing a division of earnings should be referred to as dividends and must not exceed accumulated retained earnings. Wasting asset "dividends" are not "dividends," as such, but a return of invested capital.

6. Corporate combinations should be accounted for as purchases. Precombination retained earnings have significance only to the entity through which the income was produced; transfer of retained earnings to any other entity should be prohibited.

7. Ideally, the law should not attempt to spell out inflexible rules of disclosure. It should contain general guides as to what must be disclosed to protect the rights of persons dealing with corporations. These general guides should agree with the standards of disclosure established by the accounting profession. If the Acts did provide for disclosure as recommended by the

accounting profession, they would then have built-in flexibility and would change as circumstances dictated. Such a provision would place the responsibility for disclosure of corporate financial data upon those who should and can bear this responsibility--the members of the accounting profession individually and collectively.

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CHAPTER I

INTRODUCTION

The following are among the primary purposes of incorporation law:

1. To serve as a device to permit the organization and operation of enterprises as corporate units upon fulfilment of certain statutory requirements.
2. To provide a basis for an equitable maintenance of the rights of those who may have financial dealings with corporations.

With the growth of corporate enterprise there has been an emergence of a "corporate management group" and a tendency for these professional managers to perpetuate control of enterprise. Thus, the immediate management group of a corporate unit may be a very small minority of corporate share ownership. This delegation of administration demands thorough reporting by management of its stewardship of the assets entrusted to its care to preserve the rights of creditors and owners. Whether thorough reporting has been accomplished is open to serious question. In 1937 Carman G. Blough, former Chief Accountant with the United States Securities and Exchange Commission, stated:

> The wide distribution of corporate securities, the inability of the vast majority of investors to judge the value of their investment by any close-range view and their dependence upon information contained in published financial statements, has placed a responsibility

> upon the accountants to which many of them have not yet become adjusted.[1]

More recently Kenneth C. Tiffany, vice-president of Massey-Ferguson, stated:

> If in speaking of 'economic illiteracy' or 'economic ignorance' I sound patronizing of the general public, I want to correct that impression. The public has fallen behind in its economic knowledge only because our economy has become so much more complex. I am convinced that the public is able and eager to absorb more knowledge of our economic system: the fault is with those of us who have had the necessary specialized training but have done an inadequate job of translation and communication or, perhaps worse, have tried to reduce complexities to catch phrases and charts which convey just enough accuracy to furnish dangerously little learning.[2]

The Problem

This dissertation studies the problem of inadequate disclosure of corporate financial activity by companies incorporated under the Companies Act, Canada, and the Corporations Act, Ontario.

Corporations are creatures of the state. The state, therefore, has a responsibility to protect those who have, or may have, financial dealings with corporations. One way of attaining protection is through adequate disclosure of corporate financial activity. The Companies Act, Canada, and the Corporations Act, Ontario, contain certain provisions compliance with which would purportedly furnish the desired degree of disclosure. Adequate disclosure, however, is not forthcoming in many cases. For example:

A. The statutes do not clearly recognize the distinction between invested capital and reinvested earnings. In failing to distinguish

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[1] Carman G. Blough, "The Need for Accounting Principles," The Accounting Review, XIII (March, 1937), p. 31.

[2] Kenneth C. Tiffany, "The Future of Accounting," The Accounting Review, XXXVI (April, 1961), p. 205.

between the sources of ownership equity, the statutes permit financial practices which may be misleading. The following are illustrative of these practices:

1. "Surpluses," other than retained earnings, can be recorded on the books and may be utilized improperly to eliminate accumulated operating deficits.
2. Corporate distributions to shareholders may be made under the guise of dividends (division of earnings), while there is an accumulated operating deficit.
3. "Surplus" accounts can be recorded on the books initially to give an impression of profitability which has not been proven and may not exist.

B. Both the Federal and Ontario Acts permit the misstatement of assets and of liabilities, which result in future misstatement of periodic income. For example, bond premiums and bond discounts can be written off when bond issue takes place.

C. Since the provisions of the statutes are inflexible, they become outdated and do not provide for adequate disclosure of essential financial information arising out of new developments in business and finance. An example is accounting for long-term leases.

Purpose of the Study

The purpose of this study is to determine the accounting statute revisions which will eliminate inadequate disclosure of corporate financial activity. The criteria for evaluation of statute provisions must cover the interests of both suppliers of capital and the general public. Sufficient financial information must be disclosed so that those who deal with corporations can rely upon representations in financial statements. The issue with each proposed provision is: does it provide an adequate degree of disclosure to protect the public?

In general, the statute provisions should aid the development of accounting for the following reasons:

1. To extend the concept of usefulness of accounting from the limited one of accounting as a tool of business or management, to include accountancy as an agent of present and prospective investors as well as of the general public.
2. To report fully the results of operations and to present accurately the financial position of companies.
3. To secure greater uniformity and consistency in order to facilitate comparability of results.
4. To reflect new developments in business and finance.
5. To reflect improving standards in the field of accountancy.
6. To facilitate the development and maintenance of accepted accounting principles by enforcing such standards.

Scope and Methodology

The present study is limited to the Companies Act, Canada, and the Corporations Act, Ontario. The reasons for limiting the study to these two Acts are:

1. The Companies Act, Canada, is the Federal Act and most companies, national in scope, are incorporated under this Act.

2. The Corporations Act, Ontario, is the most current incorporation statute in Canada.

The relevant statute provisions considered are those with significant accounting implications. Specifically, the statute provisions examined are those which pertain to: (1) Capital of the Corporation, (2) The Corporate Surplus, (3) Corporate Distributions to Shareholders, (4) Corporate Combinations, and (5) Disclosure of Corporate Activity.

The methodology of this study is predicated on the proposition that financial data should be treated with uniformity regardless of political boundaries. Serious differences exist between accepted accounting theory in each of the areas studied and in the accounting provisions of the Companies Act, Canada, and the Corporations Act, Ontario. In this study the statute provisions in areas delineated are compared with accounting principles and procedures enunciated by the accounting profession. The adequacy of the law and of the accounting principles and procedures is judged in the light of effecting disclosure which will inform and protect the public.

The approach proposed for remedying the situation is to recognize that the statutory concepts of "capital," "surplus," and "dividends," must be updated to current thinking and requirements. Amended provisions in these concepts should be clarified to facilitate disclosure and understanding. Disclosure practices of corporate financial activity are vulnerable to obsolescence in a dynamic and changing society. To keep abreast of the dynamism of our society, the statute provisions must be flexible. Disclosure must be recognized as the primary responsibility of accountants and the accounting profession.

Ideally, the law should not spell out inflexible rules of disclosure; it should contain guides conforming to the standards of the accounting profession and which are appropriate for the protection of the financial public of corporations.

Literature on the Problem

Literature prior to the establishment of the Securities and Exchange Commission in 1934 was "flavoured" with a caveat emptor attitude regarding public disclosure of corporate financial activity. Since that date the accounting literature has emphasized the need for adequate and meaningful disclosure of financial activity of corporations and has advanced standards of reporting which would insure such disclosure.

The most authoritative outlines of what adequate disclosure consists of are found in certain Securities and Exchange Commission Releases, Bulletins of the American Institute of Certified Public Accountants, Bulletins of the Canadian Institute of Chartered Accountants, and the rules of the New York Stock Exchange, issued from time to time.

CHAPTER II

CAPITAL OF THE CORPORATION

The Concept of Capital

There is considerable confusion in the usage of the term "capital." The fundamental difficulty is in defining what constitutes the capital of a corporation--is it the total resources in the control of the corporation or only some part thereof, such as the assets as measured by the par or assigned dollar value to shares issued to the shareholders?

The formulation of the concept of capital pre-dates Christianity by nearly four centuries. Dewing refers to Xenophon's Okonomikos, (the first important treatise on economics produced during the development of our western civilization) in which the author categorically states that true capital is that part of wealth which can be made to yield a profit.[1] Some two thousand years after Xenophon's treatise, the term capital came into usage among English trading companies. The funds that were contributed by the subscribers or shareholders for a venture were referred to as "capital." It was assumed that this amount would be returned to the shareholders, together with any profits at the end of the undertaken venture. The concepts of capital in usage today are varied, and are modifications or derivatives of these earlier formulations. Notable

[1] A. S. Dewing, Financial Policy of Corporations (New York: The Ronald Press Company, 5th Edition, 1953), p. 45 footnote b.

variations are found primarily in the interpretations of accountants, economists, and jurists.

The Accountant's Concept. - To accountants the word "capital" has a variety of meanings. Accounting Terminology[2] gives four definitions of capital which are:

1. The amount of property owned by an individual or enterprise at a specified time, . . . capital means wealth, i.e. tangible and intangible property rights.

2. The interest of the owner or proprietors in the assets of an enterprise . . . the excess of the total assets over the total liabilities to outside interests.

3. In a limited company, that portion of the equity contributed by the shareholders which may be returned to the shareholders after compliance with the formalities imposed by the governing act, the letters patent or the memorandum of association.

4. The total funds provided by lenders (borrowed capital) and by proprietors for the use of the business.

In addition, capital in estate accounting is used synonymously with the corpus of the estate.

Of the definitions cited, 1 and 4 are identical with only one difference: the former refers to the asset side of the balance sheet; the latter to the equity side. "Capital" in terms of this definition is the value,[3] expressed in money, of total resources of the corporation supplied by its creditors and owners. In definition 2, "capital" is equated to the equity of the proprietors. Definition 3 designates "capital" as the legal or stated capital and represents amounts paid or pledged and designated as capital at the time of issuance of the shares in

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[2] Accounting Terminology (Toronto: The Canadian Institute of Chartered Accountants, 1957), p. 14.

[3] The cost basis of accounting rests on the assumption that cost, or cost less accumulated depreciation, is a valid and objective quantitative measure of value.

accordance with provisions of the act under which incorporation took place. The capital so designated is intended to form a cushion for the protection of creditors and is a result of the limited liability privilege enjoyed by the shareholders.

These definitions of "capital" have broadened the range of defined limits from those established by Xenophon and the early English trading companies, and each finds strong support among members of the accounting profession. On the subject of capital, Hatfield writes:

> In the technical accounting jargon, capital is a credit account, denoting proprietorships, while "Capital assets" are debits--indicating something owned--and never the twain shall meet.[4]

> I assert that capital, capital stock, or stated capital, as an accounting term represents so much of the stockholders' contribution as is understood to be an inviolable buffer to protect creditors and possibly other stockholders, and ordinarily is not paid back to them.[5]

To Hatfield, capital, capital stock, and stated capital are synonymous and represent the amount designated as capital at the time issuance of shares takes place. His view is not shared by Paton and Paton who state:

> The capital of the business corporation, in the broad sense of all the resources employed in its operations, is furnished by those who invest in or make loans to the company plus those who supply goods and services on a credit basis.[6]

In this sense the capital of the corporation is the sum total of all items on the left hand side of the balance sheet, or the total resources, regardless of source.

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[4]H. R. Hatfield, Surplus and Dividends (Cambridge, Massachusetts: Harvard University Press, 1947), p. 3.

[5]*Ibid.*, p. 23.

[6]Wm. A. Paton and Wm. A. Paton, Jr., Corporation Accounts and Statements (New York: The Macmillan Company, 1955), p. 3.

This is viewing the corporation as a creature of the state which has to be endowed with adequate economic resources in order that it may achieve the purpose for which it has been created--this being the making of profit.[7] These economic resources are then the capital of the corporation; this definition is in agreement with that of Xenophon formulated some twenty-four centuries ago. The essential ingredient of this definition is that a definite amount of wealth has been segregated and placed at the disposal of the directors for them to employ for the purpose for which the corporation was organized.

The Economist's Concept.- The concept of capital as consisting of total assets is probably the closest approximation to what economists generally define as capital. However, concepts of capital in economics are as varied as in accounting. One prominent economist states:

> Capital, like many other words in our subject, has almost as many meanings as there are economists.[8]

To Boulding the most important meaning of "capital" is "the concept of the totality of commodities--valuable things--in existence at a moment of time."[9] Applying this concept to the corporation, capital is the aggregation of "economic service potentials" awaiting conversion into more desirable forms through the operation of the enterprise. The distinction between the "economic service potential" concept and the total asset concept is that the economist limits himself to material

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[7]The notion of the corporation as an institution to perform some social purpose is here disregarded; most accountants and financiers believe that profit is the purpose for formation; Dewing so states, op. cit., p. 44.

[8]K. E. Boulding, Economic Analysis (New York: Harper & Brothers Publishers, Revised Edition, 1948), p. 262.

[9]Ibid., p. 263.

wealth. Alfred Marshall states:

> . . . But there is a clear tradition that we should speak of Capital when considering things as agents of production . . . [10]

More recently Harry G. Shaffer states:

> . . . during the first half of the twentieth century. . . the overwhelming majority of economists, following Alfred Marshall have shown a tendency to use the concept of capital as applicable only to that portion of the non-human, material man-made stock of wealth which is utilized directly in further production. [11]

Limiting capital to material wealth used in production leads to neglect of the value of intangibles which may be very important since the value of tangible goods tends to become increasingly dependent upon their organized relationship to other tangible goods within the corporate unit.

The Legal Concept of Capital. - One of the functions of a general Companies Act is to provide a legal vehicle whereby a number of individuals, each investing a comparatively small amount, may combine their resources in an aggregate sufficient for a particular undertaking. In return each individual presumably secures a due measure of influence in the management of the created corporation and each receives a due proportion of its profits. The distinguishing feature of the corporation from a partnership is that persons investing in the corporate enterprise do not have a direct ownership of the corporation's property; they are owners of an intermediate and fictitious body of property called the corporation's stock. The corporation owns the property. Thus the corporation is in law a

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[10] Alfred Marshall, Principles of Economics (London: Macmillan and Co., Limited, Eighth Edition, 1938), p. 81.

[11] Harry G. Schaffer, "Investment in Human Capital: Comment," The American Economic Review, LI (December, 1961), p. 1026.

different person from its members, and the debts and obligations of the corporation are not those of its members but of the corporation itself. In recognizing the right of limited liability of the corporate members, provided the members did not violate the provisions of the Act granting them this immunity, the courts were faced with the problem of protecting the creditor's rights, vis-a-vis the persons who control the corporation.

It is in this connection that the "trust fund theory" came into being. In the case of Wood v. Dummer,[12] Chief Justice Story stated that the capital stock of a corporation constitutes a trust fund for the payment of its debts to creditors. Although the theory, by name, has gone out of usage, the spirit and its influence on accounting is very much in evidence.[13] The terminology that has been substituted is legal or stated capital; the function is, however, the same--a cushion or buffer for the protection of creditors.

Legal definition of capital is still based on the idea that a corporation must have a fund of property to be called capital--legal capital or stated capital, even though there is a considerable lack of clarity as to what should constitute the capital of the corporation. With the advent of no-par and nominal low par value stock, the directors in many jurisdictions have been left to decide, usually within stated limits, what should constitute legal or stated capital. The legal concept has therefore been rendered obsolete. Although some accountants bemoan the legal

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[12]Wood v. Dummer, 3 Mason (U.S.C.C. 1824), discussed in James T. Johnson, "Is The Trust Theory of Capital Stock Dead," The Accounting Review, XXXIV (October, 1959), pp. 609-11.

[13]The weakness of the trust fund theory is in its implication that the corporation was to act as a trustee holding the assets contributed by the shareholders in substantially original form for the protection of creditors. It is doubtful whether the statutes and even Chief Justice Story intended this.

influence on accounting, e.g.,

> Accounting has never been able to throw off the yoke of legal capital from corporate stock equity reporting.[14]

the inadequacies of legal interpretation must be shared by both professions. On this, George O. May has stated:

> The courts are not expert in accounting, and our methods of informing them on technical matters are deficient . . .[15]

On the subject of capital, a noted Canadian author on Corporation Law stated:

> It should be observed that the company may have other capital besides its stock, or, as it is sometimes called, its "share capital." The company may borrow money on bonds or other securities, or without security, and money so borrowed is sometimes called "borrowed capital" to distinguish it from the capital stock. The company may also have accumulated reserves, which may be treated as capital. Primarily, however, in speaking of the capital of a company, the reference is to its capital stock. But the meaning of the term in the statute depends on the content, and in the provision prohibiting payment of dividends out of capital the term capital undoubtedly includes borrowed capital.[16]

It is thus apparent that the term capital has a variety of meanings in accounting, in economics, and in jurisprudence. The phrase out of Wegenast's statement (above), "But the meaning of the term in the statute depends on the context," is probably the thinking behind the distinction made as to the type of capital by the American Accounting Association and the American Institute of Certified Public Accountants. The former has drawn a distinction between types of capital by the addition of the words "paid-in" and states:

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[14]Wm. J. Vatter, Handbook of Modern Accounting Theory, Morton Backer, Editor, (New York: Prentice-Hall Inc., 1955), pp. 374-75.

[15]George O. May, "Accounting and Regulation," The Journal of Accountancy, LXXVI (October, 1943), p. 295.

[16]F.W. Wegenast, The Law of Canadian Companies (Toronto: Burroughs and Co. (Eastern) Ltd., 1931), p. 444.

> Paid-in capital is measured by the cash, or the 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.[17]

The recommendation of the A. A. A. with regard to capital is in support:

> 2. The contributed portion of proprietory capital be shown as:
>
> (a) Capital contributed for, or assigned to, shares, to the extent of the par or stated value of each class of shares presently outstanding.
>
> (b) i) Capital contributed for, or assigned to, shares in excess of such par or stated value (whether as a result of original issue of shares at amounts in excess of their then par or stated value of shares after issuance, or of transactions by the corporation in its own shares); and
>
> ii) Capital received other than for shares whether from shareholders or from others.[18]

These are the concepts of capital as enunciated by leading authorities in accounting, economics and jurisprudence.

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[17] Committee on Accounting Concepts and Standards, Accounting Concepts and Standards Underlying Corporate Financial Statements and Supplements, American Accounting Association, 1948, p. 4.

[18] Committee on Terminology, Accounting Terminology Bulletin No. 1, American Institute of Certified Public Accountants, 1953, pp. 30-1.

"Capital" in Canadian Corporation Law

The Companies Act, Canada:

Section 12, subsections:

(5) The authorized capital of a company having shares with a nominal or par value shall, with respect to those shares, be the total nominal amount of those shares.

(6) All or any part of the authorized capital of a company, except shares having priority as to capital or being subject to redemption, may consist of shares without nominal or par value.

(7) Where the authorized capital of a company consists, in whole or in part, of shares without nominal or par value the paid up capital of the company shall, with respect to those shares, be an amount equal to the aggregate amount of consideration received by the company for such of those shares as are issued, exclusive of such part of such consideration as may be set aside as distributable surplus in accordance with the provisions of this Part or as may have been lawfully set aside as distributable surplus before the 1st day of October, 1934.

(8) Each share of the capital stock without nominal or par value shall be equal to every other such share of the capital stock subject to the preferred, deferred or other special rights or restrictions, conditions or limitations attached to any class of shares.

(9) Every certificate of shares without nominal or par value shall have plainly written or printed upon its face the number of such shares which it represents and the number of such shares that the company is authorized to issue, and no such certificate shall express any nominal or par value of such shares.

(10) In the absence of other provisions in that behalf in the letters patent, supplementary letters patent or by-laws

of the company, the issue and allotment of shares without nominal or par value may be made from time to time for such consideration as may be fixed by the board of directors of the company; and in fixing the amount of such consideration, the board, subject to the provisions of this Part, may provide in the contract of subscription for such shares that the consideration received therefor shall be deemed to be capital, excepting a part, if any, not exceeding twenty-five per cent thereof, that may be set aside as distributable surplus; and where the company acquires a going concern that has a surplus over and above all liabilities, and any shares without nominal or par value in the company are issued and allotted as fully paid in payment or part payment for such going concern, the directors may by resolution set aside, as a distributable surplus, such part of the consideration for the issue and allotment of such shares without nominal or par value as does not exceed the unappropriated balance of realized net profits of the going concern immediately before such acquisition.

(11) Any and all shares issued as permitted by this section shall be deemed fully paid and non-assessable on receipt by the company of the consideration for the issue and allotment thereof, and the holder of such shares shall not be liable to the company or to its creditors in respect thereof.

(12) Shares in the capital stock of the company having a nominal or par value shall not be issued as fully paid except for a consideration payable in cash to the total nominal amount of the shares so issued, or for a consideration payable in property or services that the directors may determine by express resolution to be in all the circumstances of the transaction the fair equivalent of cash to the total nominal amount of the shares so issued.

(13) The directors may apply ex parte by summary petition to a judge to determine by declaratory order that any such consideration so payable in property or services is such fair equivalent as aforesaid; such judge may so determine and for that purpose he may require the production of such proofs, oral and documentary, under oath or otherwise, as he may think fit, and his order shall be final and conclusive proof in all courts that such consideration so payable was such fair equivalent as aforesaid.

Section 16, subsections:

(1) It shall be lawful for a company to pay a commission to any

person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the capital stock of the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any such shares if

(a) the payment of the commission is authorized by the letters patent or supplementary letters patent,
(b) the commission paid or agreed to be paid does not exceed the amount or rate so authorized, and
(c) the amount or rate per cent of the commission paid or agreed to be paid is disclosed in the prospectus in the case of shares offered to the public for subscription.

(2) Save as aforesaid, no company shall apply any of its shares or capital money either directly or indirectly in payment of any commission, discount, or allowance, to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the capital stock of the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any such shares, whether the shares or money are so applied by being added to the purchase money of any property acquired by the company or to the contract price of any work to be executed for the company, or the money is paid out of the nominal purchase money or contract price, or otherwise.

(3) Nothing in this section affects the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay, and a vendor to, promoter of, or other person who receives payment in money or shares from a company, shall have and shall be deemed always to have had power to apply any part of the money or shares so received in payment of any commission, the payment of which, if made directly by the company would have been legal under this section. 1934, c. 33, s. 16.

The Corporations Act, Ontario:

Section 30, subsections:

(1) Where the shares of a company are with par value, its issued capital shall be expressed in dollars, pounds, francs or other currency and is an amount equal to the total of the products of the number of issued shares of each class multiplied by the par value thereof.

(2) Where the shares of a company are without par value or where part of its shares are with par value and part are without par value, its issued capital shall be expressed in dollars, pounds, francs or other currency and is an amount equal to the total of the products of the number of issued shares of each class with par value multiplied by the par value thereof, together with the amount of the consideration for which the shares without par value from time to time outstanding were issued and together with such amounts as from time to time by by-law of the company may be transferred thereto.

(3) Nothing in subsection 2 affects the capital of a company in respect of shares without par value issued before the 30th day of April, 1954, if the letters patent or the supplementary letters patent of the company provide that the capital is to be at least equal to the sum of the aggregate par value of all issued shares having par value plus a sum in dollars, pounds, francs or other currency in respect of every issued share without par value plus such amounts as from time to time by by-law of the company may be transferred thereto.

(4) Where before the 30th day of April, 1954, a company has set aside part of the consideration received upon the allotment and issue of shares without par value as distributable surplus, the amount of such distributable surplus shall not form part of its issued capital. 1953, c. 19, s. 30.

Section 31, subsections:

(1) In the absence of a provision to the contrary in the letters patent, supplementary letters patent or by-laws of the company, shares may be allotted and issued at such times and in such manner and to such persons or class of persons as the directors determine.

(2) Shares with par value shall not be allotted and issued as fully paid except for a consideration payable in cash at least equal to the product of the number of shares allotted and issued multiplied by the par value thereof or for a consideration payable directly or indirectly in property or past services which the directors in good faith determine by express resolution to be in all circumstances of the transaction the fair equivalent of such cash consideration.

(3) Shares without par value may be allotted and issued for such consideration as may be fixed by the directors acting

in good faith and in the best interests of the company.

(4) Shares without par value shall not be allotted and issued as fully paid except for the consideration fixed by the directors as aforesaid payable in cash to the total amount of the consideration so fixed or for a consideration payable directly or indirectly in property or past services which the directors in good faith determine by express resolution to be in all circumstances of the transaction the fair equivalent of such cash consideration.

(5) Shares allotted and issued in accordance with this section shall be fully paid and non-assessable upon receipt by the company of the consideration for the allotment and issue thereof, and upon such receipt the holders of such shares shall not be liable to the company or to its creditors in respect thereof. 1953, c. 19, s. 31.

Section 32, subsections:

(1) The directors may pass by-laws for the payment of commissions to persons in consideration of their subscribing or agreeing to subscribe, whether absolutely or conditionally, for shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional for such shares, but no commission shall exceed 25 per cent of the amount of the subscription.

(2) No by-law passed under subsection 1 shall be effective until it is confirmed by at least two-thirds of the votes cast at a general meeting of shareholders duly called for considering the by-law.

(3) Except as provided in subsection 1, no company shall apply any of its shares or capital, either directly or indirectly, in payment of any commission, discount or allowance to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for shares of the company or procuring or agreeing to procure subscriptions, whether absolute or conditional, for such shares, whether the shares or capital is so applied by being added to the purchase money of any property acquired by the company or to the contract price of any work to be executed for the company, or is paid out of the nominal purchase money or contract price or otherwise. 1953, c. 19, s. 32.

"Capital" as defined by the Federal Act is as follows: In the case of par value shares, "capital" is the product of the number of issued shares of each class multiplied by the par value thereof. In the case of no par value shares, "capital" is any amount established by the directors within the 75 per cent to 100 per cent limits of the total consideration for issued shares.

"Capital" under the Ontario Act is: In the case of par value shares, "capital" is the product of the number of issued shares of each class multiplied by the par value thereof. In the case of no par value shares, "capital" is the total consideration received. The accounting entries under the two statutes would then appear as follows, assuming ten no par shares were issued for a total consideration of $120.

Federal Act:

Assets	$120	
Share Capital		$90
Distributable Surplus[19]		30

Ontario Act:

Assets	$120	
Share Capital		$120

In effect the Federal Act permits the understatement of "capital" by an amount of up to $30, in the above example (up to 25 per cent of the total consideration) in terms of the Ontario Act, or in terms of the concept of capital which views total proceeds of an issue of shares as legal capital. The provision of the Ontario Act

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[19] In the example it is assumed that the minimum amount allowable by law is designated as legal capital and the maximum amount designated as distributable surplus. It is within the power of the directors to designate any amount within the 75-100% limits of agreed consideration as legal capital and the balance as distributable surplus. The amount by which the total consideration exceeds stated or legal capital is set up as "Distributable Surplus" and is dealt with in the next chapter. . . "The Nature of Corporate Surplus."

requiring total proceeds from issue of no par shares is applicable only to share issues since April, 1954. Companies which allocated a portion of the proceeds to distributable surplus prior to this date were not required to alter their accounts to conform to the new Ontario legislation. The Act therefore sets up a double standard for new and old companies and relegates the provision of the Act to a "lame-duck" status. The Act should have allowed companies a period of time to conform to new legislation. An interesting and questionable provision in both Acts (Section 16 in Federal and Section 32 in Ontario) allows in effect the overstatement of legal capital. Both Acts permit the payment of commissions of up to 20 per cent to any person other than underwriters or selling groups subscribing to shares directly from the company. The accounting entries follow:

Assets	\$100	
Share Capital		\$100
Commissions on Share Capital (intangible asset)	\$20	
Assets		\$20

Since the companies are empowered to pay commissions directly to the subscribers, in essence refunding a portion of the subscribers contribution, the Acts essentially legalize the issuance of shares at a discount, which the Acts, at the same time, specifically declare to be illegal.[20] On the subject of commissions, Professor Smails states:

> In legal theory therefore these commissions represent an asset which endures without impairment so long as the shares in question are outstanding and one which might properly be left standing on the books at its original figure for that period

[20]The Corporations Act, Ontario, specifically exempts mining companies from the provision prohibiting the issuance of shares at a discount.

> of time. But the power to pay commissions may be used as a device for issuing par value shares at a discount and when it is so used the facts do not fit the legal theory--the paid-in capital is in fact overstated and the error can be corrected only by capitalizing a corresponding amount of earned surplus.[21]

Recognizing commissions as bona fide assets is interpreting the expenditure as a financial cost, utilizing part of the funds invested to pay for necessary services. However, when only two parties are involved, the company issuing shares and the investor, an allowance of a commission is not a payment for a necessary service--no service is involved. The validity of compensating a person for his efforts in selling shares to himself is beyond justification. From the purchasers' or subscribers' point of view recognizing commissions as revenues is similar in nature to recording purchases subject to discounts at gross amounts and recognizing discounts taken as revenue, which only can be justified on the acceptance of Poor Richard's "a penny saved is a penny earned."

Remedying the situation as suggested by Professor Smails is not acceptable. Capitalizing earned surplus (increasing stated capital and decreasing earned surplus) in amount equal to commissions is only compounding the "error." This practice not only assumes the presence of earned surplus, but would understate the earned surplus and further overstate the stated capital. The "error" can only be corrected by wiping out the fictitious asset and reducing stated capital.

Under the circumstances stated above, commissions do not qualify as a financing cost, hence do not qualify as an asset. On the other hand, since they were granted voluntarily they cannot be regarded as a loss. Therefore, the only

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[21] R. C. H. Smails, Accounting Principles and Practice (Toronto: The Ryerson Press, Revised Edition 1954), p. 288.

correct interpretation of commissions when only two parties are involved is that they are, in fact, discounts, and recording an issue of stock at par or stated value under this condition constitutes an overstatement of capital.

There was a partial attempt to remedy the situation in the Ontario Act. Commissions that are granted cannot exceed 25 per cent of the subscribed amount. This is somewhat of an improvement over the Federal Act where no limit is set; however, room is still left for abuse and very little, if anything, is accomplished in clarifying the concept of legal capital.

The consideration of commissions above applies to situations where only two parties are involved. Where a third party is involved and the dealings are at arms' length, a valid consideration is received by the issuing company. The services performed by the third party, such as the assumption of certain risks associated with an underwriting, advice as to timing and type of security to be issued, etc., are valid assets which rank pari passu with other assets acquired by the corporation and are rightly recognized and retained on the books.[22]

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[22]This is the view of Paton and Paton who state: "Organization and related costs should be retained as a permanent asset as long as the business maintains substantially unimpaired status as a going concern, as reflected in earning power and tangible resources, and should be amortized with a sustained contraction of income and tangible assets resulting either from lack of operating success or deliberate liquidation. Needless to say it would not be expedient to attempt to apply such a formula in terms of minor fluctuations in activity and earning power." Wm. A. Paton and Wm. A. Paton, Jr., Asset Accounting (New York: The Macmillan Co., 1952), p. 472. To argue against the viewpoint of Paton and Paton on the basis that the only capital available to the management of a corporation is the proceeds net and organization and related costs are not bona fide assets since the corporate management can do nothing with these assets may be valid only from the viewpoint of the financial officer. However from the accounting viewpoint the argument loses any validity that it may have.

Other Cases of Overstatement or Understatement of Capital

Implicit Stock Discounts

The issue of shares for a consideration other than cash may give rise to an implicit discount in the transaction. Although the statutory provisions prohibit the issue of shares for a wholly illusory consideration, in reality the board of directors is given wide latitude in establishing asset values. J. L. Stewart states:

> . . . in the absence of fraud or special statutory requirements, neither the court, while the company is a going concern, nor the liquidator, if the company is being wound up, will enquire into the adequacy of the consideration.[23]

When assets are acquired in exchange for shares of the company and these assets are overvalued, in terms of market value, the issued shares are only nominally paid in full and an implicit discount equal to the overvaluation of the assets acquired exists. To illustrate assume that an asset can be acquired for $1,000 in cash; however by mutual agreement the asset is exchanged for $1,500 par value shares. The accounting entry, avoiding recognition of the implicit discount, would appear as follows:

Asset	$1,500	
Share Capital		$1,500

In the example, the effect of the entry is to overstate the legal capital by $500, the amount of the implicit discount.

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[23] J. L. Stewart, Handbook on Canadian Company Law (Toronto: The Carswell Co. Ltd., Fifth Edition, 1960), p. 67.

Secret Reserves

Although understatement is usually associated with the measurement of net income and retained earnings, situations do arise where undervaluation of invested noncash assets or suppression of costs of intangibles take place. To illustrate assume that because of a tax advantage, to gain control of a company, or to make a donation to a company, an owner of an asset, the market value of which is $1,500, agrees to accept $1,000 par value shares in exchange for the asset. The accounting entry recognizing the asset on the books at $1,000 is as follows:

Asset	$1,000	
Share Capital		$1,000

The effect of the entry is to understate legal capital by $500, the amount of the undervaluation of the asset. As in the case of implicit stock discounts, the practice of recognizing assets on the books at undervalued values is difficult to eliminate by legal provisions. Both the Federal and Ontario Acts leave it up to the board of directors to determine in good faith the fair equivalent of such noncash consideration. The Federal Act, in addition, provides that the directors may apply to a judge to determine by declaratory order that the valuation of the consideration by the directors is a fair equivalent of cash. However, even this additional provision is of questionable value, as stated by F.W. Wegenast:

> If a man has subscribed for $1,000 of stock and has paid $999, the court will do a sum in subtraction and make him pay the other dollar. But, if for $1,000 of stock a man turns in property which could readily be shown to be worth only $10 the theory is that the court is helpless. In an automobile accident the court can assess the value of an arm or an eye. In a libel suit it can assess the

> value of a character. But the line is drawn when it comes to assessing the value of assets given for stock in a company.[24]

The courts have taken the attitude that valuation of assets, other than cash, exchanged for shares of the corporation, is the prerogative of the board of directors. Only in situations where fraudulent dealings are present in connection with the exchange of non-cash assets will the courts interfere. However even in these cases where fraud is involved, the fraudulent practice is the basis for interference and not the valuation of the assets per se.

In adopting the "hands-off" policy toward asset valuation, the courts no doubt were influenced by the fact that the alternate courses of action may not be workable in practice. Although valuation of non-cash assets exchanged for shares of corporations' might be delegated to the courts, the problems involved in valuation would not be eliminated. Assets exchanged for shares are for the most part unique in character; the fair value of these is subjective and the values assigned by the courts may not be any more accurate than the value that would otherwise be assigned by the directors.

The delegation of authority to the directors in the valuation of non-cash assets exchanged for shares of the company finds theoretical foundation; the directors are the representatives of the shareholders and act in their (the shareholders') best interest.

In the United States the "hands-off" policy is not applicable. The Security and Exchange Commission in its early life in a number of cases established its right to question asset valuation.

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[24] Canadian Political Science Association, Papers and Proceedings of the Annual Meeting (Ottawa, Ont., 1933), p. 160.

Subsequent Changes in Capital

Although both incorporating acts set out restrictions which govern companies on such matters as the preservation of capital, they also provide means by which changes in the capital structure may be effected in order that the continuing company may have a degree of flexibility in its financial arrangements. In general, alterations which change the details of the original share contracts without changing the amount of legal capital, or the right of shareholders, require only the assent of two-thirds of the votes of the holders of each class of shares affected (cast at a special meeting of shareholders) and the formality of changing the charter. Those changes which result in reduction of legal capital and/or involve the rights of either or both the shareholders and creditors can be effected only by formal approval of shareholders, creditors, and the Secretary of State of the appropriate jurisdiction.

There is considerable variation between the Federal and the Ontario Acts, and the provisions of each will be discussed separately.

<u>The Companies Act, Canada</u>

Changes Not Reducing Legal Capital:

Under section 48, the company, with the approval of two-thirds of the votes of the holders of each class of shares, may from time to time by by-law:

(a) subdivide any shares with or without par value of any class;

(b) consolidate all shares with par value, of any class, into shares of larger par value not exceeding the par value of one hundred dollars each;

(c) consolidate all shares without par value, of any class, so that the authorized number of such shares is reduced;

(d) change all or any of its previously authorized shares with par value, issued or unissued, into the same or a different number of shares of any class or classes without par value and not having priority as to capital or being subject to redemption;

(e) change all or any of its previously authorized shares without par value, issued or unissued, into the same or a different number of shares of any class or classes with par value;

(f) classify or reclassify any shares without par value;

(g) increase the capital of the company; and

(h) cancel any shares with or without par value, that at the date of the enactment of the by-law have not been subscribed for or agreed to be issued, and diminish the amount of the authorized capital of the company by the amount of the shares so cancelled.

Alterations under this section usually require only a memorandum entry. The one exception is that on consolidations of shares fractional shares usually arise. The company is permitted to purchase such fractional shares; however, it must sell the resulting whole shares within two years. This is a specific legal exception to the rule under common law which does not permit companies to trade in their own stock.

By section 59, the company, with the same approval as above, can create and issue preferred shares with such preferred or other special rights, restrictions, conditions or limitations as may be set out in the by-law. This section permits inclusion, with approval, of a redemption or conversion feature if these were not included in the original contract.

Alteration of the rights of shareholders can be effected under Section 126; however, approval by at least three-fourths of the shares of each class represented and voted at a special meeting of shareholders is required.

A provision that is rare in corporation law is section 61 of the Act which permits the redemption or purchase for cancellation of any of its fully paid shares, other than common, without the usual formalities of sections dealing with the reduction of capital. The Act specifically requires in this connection that: either (a) the redemption must be made out of proceeds of an issue of new shares for the purpose; or (b) it is made by payments out of the ascertained profits of the company--these profits must have been set aside by the directors for the purpose of redemption and are in liquid funds as shown by the audited balance sheet dated not more than ninety days before the redemption or purchase for cancellation. Cumulative dividends on the preferred stock must not be in arrears; the legal capital of the company is not to be reduced; notice of redemption must be filed with the Secretary of State.

The condition of not reducing the legal capital is accomplished in two ways: in case (a) above, the new shares replace those redeemed, and (b), a transfer from retained earnings to "capital surplus" in the amount equal to the legal capital associated with the redeemed shares must be made.

Thus, the Act seeks to protect the creditors by requiring that no impairment of capital, (that is, reduction of legal capital), takes place as a result of redemption or purchase for cancellation of shares other than common.

Illustration of accounting procedure involved follows:[25]

The shareholders' section of the balance sheet of XYZ Limited as of June 30, 1961, appears below:

Share Capital:

Preferred shares, authorized, issued and fully paid, 1,000 6% redeemable preference shares of $10 par	$10,000
Common shares, no par-value, authorized issued and fully paid, 10,000 shares	50,000
Retained Earnings	30,000
	$90,000

1. Assume Redemption is made out of proceeds of new issue of 4% preferred.

Transactions:

Cash	$10,000	
4% preferred stock		$10,000
Issue of new 4% preferred shares		
6% preferred stock	10,000	
Cash		10,000
Redemption of 6% preferred shares		

No changes in portion of balance sheet shown above.

2. Assume redemption is made without any new issue of stock.

Transactions:

6% preferred stock	$10,000	
Cash		$10,000
Redemption of 6% preferred shares		
Retained earnings	10,000	
Capital surplus (sec. 61)		10,000
To record transfer from retained earnings.		

In the second example after transactions were made, the shareholder's section of the balance sheet would change.

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[25]Illustrations adapted from H. A. Finney and H. E. Miller, Principles of Accounting, Intermediate, Canadian Edition, prepared by K. F. Byrd, (Englewood Cliffs, 1959) and W. E. Karrenbrock and Harry Simons, Intermediate Accounting, Canadian Revision, by W. J. McDougall (Toronto: W. J. Gage Limited, 1961).

Share Capital:

Common shares, no par value authorized, issued and fully paid, 10,000 shares	$50,000
Capital surplus (under Section 61 of Companies Act, Canada, 1952)	10,000
Retained Earnings	20,000
	$80,000

Because the capitalized retained earnings are, for all purposes, equivalent to capital stock, the legal capital remains the same after redemption; that is, at $60,000.

In the case of redemption premiums, the Act implies that these are to be charged to retained earnings. However, Canadian Institute of Chartered Accounts state in Bulletin No. 11:

> . . . a charge which is the direct opposite of a credit previously carried to contributed surplus--for example, where contributed surplus reflects premiums on an issue of preferred shares it is appropriate to offset premiums on redemption of shares of that issue, pro-rata.[26]

If the premium on issued preferred shares is available for dividends, as it is under the Act, there seems to be no contravention of intentions and both methods are permissible. The Canadian Institute's opinion is shared in the United States by the Chief Accountant of the Securities and Exchange Commission, who stated:

> . . . if the redemption price exceeds the amount paid in on such shares, the excess should ordinarily be charged to earned surplus.[27]

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[26] Committee on Accounting and Auditing Research, Accounting and Auditing Practices Bulletin No. 11, (Toronto: The Canadian Institute of Chartered Accountants, 1955), p. 4.

[27] Securities and Exchange Commission, Accounting Series Releases, (Washington: Securities and Exchange Commission, 1956), p. 110.

The Chief Accountant agrees with the opinion that the premium on issue of preferred shares should be reduced pro-rata when the shares are redeemed and if the redemption price exceeds the amount paid on the shares being redeemed only the excess should be charged to earned surplus.

No special accounting problem is presented in connection with conversion of convertible securities, such as bonds or preferred shares. These are convertible at the option of the security holder and may take place without special authorization. If, for example, a company had $10,000 par bonds outstanding which were convertible into 1,000 shares of the company's stock, then on conversion the following entry would cover the exchange:

Convertible bonds outstanding	$10,000	
Common stock		$10,000

Preferred share conversion would be similarly treated; that is, the corresponding credit to common stock would equal the par of the preferred converted. In cases where a premium relating to bonds or preferred shares being converted is on the books, two acceptable accounting methods may be followed.[28] Under one method the corresponding credit to share capital will be equal to the par of the security converted, plus the premium applicable to the security so converted. In situations where a bond discount is on the books, the corresponding credit is reduced by an applicable amount of the discount. Under the alternative method share capital would be credited by the total market value of shares issued and

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[28]Paton and Paton recommend crediting share capital for the par value plus the applicable premium to securities converted. However, they see no objection to crediting share capital by the market value and debiting retained earnings for balance. Wm. A. Paton and Wm. A. Paton, Jr., Corporation Accounts and Statements, op. cit., pp. 243-44.

retained earnings debited for the difference. For instance, assume, in the case of bonds above, that market value of the 1,000 shares issued on conversion was $15,000; then the entry would be:

Convertible bonds outstanding	$10,000	
Retained Earnings	5,000	
Share Capital		$15,000

Preferred share conversion would be similarly treated.

Reduction of Capital

Sections 49 to 58 inclusive outline the procedure to be followed in revision and realignment of securities usually referred to as reorganization or recasting of the capital structure. The Act sets out three types of capital reduction, with the stipulated requirement that the company have the formal approval of the shareholders, creditors, and the Secretary of State. The legal capital may be reduced under section 49 (1) for the following reasons:

(a) extinguish or reduce the liability of any of its shares in respect to capital not paid-up;

(b) cancel any paid-up capital which is lost or unrepresented by available assets, and

(c) pay off any paid-up capital that is in excess of the wants of the company.

The method that most easily accomplishes contraction of capital is releasing formal capital to the status of an "excess" (capital surplus). This may be accomplished by the reduction of par value in the case of par stock, and stated value in the case of no-par stock. The "excess" so created, may then be utilized for absorbing an accumulated deficit, writing down of asset values, or return of capital to the shareholders.

To illustrate the above method of capital contraction, assume that a company has 100,000 shares outstanding issued at a stated value of $10 and an accumulated deficit of $300,000. Steps are taken to eliminate the accumulated deficit against the excess arising upon the reduction of stated value from $10 to $5 without changing the number of shares outstanding:

(1) Capital stock (amount received from shareholders)	$1,000,000	
Capital Stock - Stated Value		$500,000
Capital Surplus from Reduction in stated value of Outstanding Stock		500,000
(2) Capital Surplus from Reduction in stated value of Outstanding Stock	$300,000	
Accumulated Deficit		$300,000

The Canadian Institute recommends that subsequent to a reduction of capital:

> If any deficit has been eliminated by reduction of share capital, reduction of contributed surplus, or other financial rearrangement, the description of earned surplus thereafter for a period of say five years should indicate the time from which the new earned surplus dates.[29]

The Act also requires that the words "and reduced" be added as the last words of the corporation's name until such date as the Secretary of State may fix.

Although accounting entries for reorganizations may take different forms, they would be basically the same if a new corporate entity is not created. Variations of the illustration are in order to conform to the specific situation of the reorganization. Radical readjustments of the capital structure may require the creation of a new corporation to take over the assets of the corporation being reorganized. Accounting for these situations is dependent on the agreement

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[29]Committee on Accounting and Auditing Research, op. cit., p. 4. The Securities and Exchange Commission recommends that the period be at least three years; however, in practice it is often continued indefinitely.

reached by the parties involved, as all parties usually agree to some sacrifice. The rule that is usually followed in such situations is that the plan for reorganization be fair to all interests. In situations of this type, sufficient protection of rights is afforded by the courts, which must approve the reorganization, and the protective committees representing the various interests.

<u>The Corporations Act, Ontario</u>

As already stated, there is considerable variation in provisions dealing with changes in capital under the two Acts. The Ontario Act provides more latitude and therefore a greater degree of flexibility for companies in their financial arrangements than does the Federal Act. Under section 33 (1) of the Ontario Act the company, after authorization by a special resolution, may apply to the Lieutenant-Governor for the issuance of supplementary letters patent[30] to permit, among other things:

(a) increasing its authorized capital;

(b) decreasing,
  (i) its authorized capital by cancelling issued or unissued shares with or without par value or by reducing the par value of issued or unissued shares, or
  (ii) its issued capital, if it has shares without par value, and where it has more capital than it requires, authorizing the repayment of capital to the shareholders to the extent that the issued capital is decreased in any way under this clause;

(c) redividing its authorized capital into shares of lesser or greater par value;

(d) consolidating or subdividing any of its shares without par value;

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[30]The procedure in obtaining supplementary letters patent is essentially the same as in obtaining the charter of incorporation.

(e) changing any of its shares with par value into shares without par value;

(f) changing any of its shares without par value into shares with par value;

(g) reclassifying any shares with or without par value into shares of a different class.

In addition, section 27, the following subsections state:

(9) Where the letters patent or supplementary letters patent provide that the preference shares may be purchased for cancellation by the company, the company may purchase some or all of such shares at the lowest price at which, in the opinion of the directors, such shares are obtainable, but not exceeding the amount paid up thereon, but if the letters patent or supplementary letters patent so provide, a premium, unpaid dividends, or other stated amount may be paid.

(10) Preference shares shall not be redeemed or purchased for cancellation by the company if the company is insolvent or if the redemption or purchase would render the company insolvent.

(11) Where preference shares are redeemed or purchased for cancellation by the company, they shall be thereby cancelled, and the authorized and the issued capital of the company shall be thereby decreased.

(12) Where preference shares are converted into the same or another number of shares of another class or classes, whether preference or common, the shares converted thereupon become the same in all respects as the shares of the class or classes respectively into which they are converted and the number of shares of each class affected by the conversion is changed accordingly.

(13) Where preference shares are converted into another class or other classes of shares, the issued capital of the company shall not be increased or decreased by the conversion.

Thus, under the Ontario Act, companies may reduce their legal capital by the purchase of both its preferred and/or common shares. The conditions of purchase are:

(a) authorized by a special resolution and issue of supplementary letters patent;

(b) that the shares purchased will be cancelled, and

(c) after the purchase, the company will be solvent and the creditors do not object to the reduction of legal capital.

Conditions (a) and (c) above are common in corporate law under which companies are permitted to purchase their own shares. However (b) requiring the cancellation of the purchased shares is not common to all jurisdiction; especially is this true in the United States, where companies in some States are permitted to purchase, carry on their books and reissue their own shares. The Ontario Act is specific on this: purchased shares must be cancelled and constitute a reduction of capital. In other words, there is no such thing as "Treasury Stock."[31] The Act recognizes that a corporation cannot hold its own stock.

In addition to requiring the cancellation of the purchased stock, the Ontario Act specifically provides the accounting that is to be followed in connection with the purchase of the company's own shares. The method prescribed is the "par-value method" which has received support from Paton and Littleton who

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[31]On "Treasury Stock" F.W. Wegenast states: Another term sometimes used instead of "authorized capital" is "treasury stock" or "stock in treasury." These expressions have no proper place in the terminology of a Canadian Company. They are popularly but incorrectly used in referring to stock which the company is authorized to issue but has not yet issued and which is therefore not in existence. The terms have come into use in Canada by way of the United States, where they are used to denote stock which has been paid up and left in the hands of the company to be issued or transferred by it without regard to the par value of the stock. Such a trafficking by a company in its own stock is not permissible in this country, i.e. in Canada. F.W. Wegenast, The Law of Canadian Companies, op. cit., p. 444.

state:

> If the shares are not reissuable, or if they take on the status of unissued or retired shares, the amount paid should be charged to capital stock account, up to the amount originally credited therein, any balance remaining should be charged to paid-in surplus up to an amount not in excess of the pro-rata portion of paid-in surplus applicable to the shares in question; any part of the total payment which cannot be thus absorbed should be charged to earned surplus.[32]

The Ontario Act recognizes that acquisition of outstanding shares by the issuing company is in effect a withdrawal of invested assets by the security holder. As a result of this, corporate capital has been correspondingly changed. The treatment of reacquisition of shares as discussed above is a significant departure of the Ontario Act from the Federal Act, which prohibits acquisition of common shares and permits acquisition and cancellation of preferred shares on the condition that an amount of retained earnings equal to the par or stated value of preferred so redeemed is capitalized.

Reconsideration of the Concepts of Capital

The legal concept of capital, which is also Hatfield's concept, that capital is the amount designated as such at the time of issuance of shares, is obsolete. It is indeed a folly to look at the figure assigned to capital stock as the capital of the corporation, and a greater folly to look at this figure as representing the assets which form a buffer or cushion for the protection of creditors.

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[32]Wm. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, 8th Printing,(1957), American Accounting Association, p. 115.

The implication of this latter concept is that credit is granted on the basis of the amount credited to the capital stock account. This is a static or sterile concept of capital not consistent with reality. In reality, credit is granted on the basis of the earning power[33] of the corporate unit without regard to the figure associated with the capital stock of the corporation. In many cases credit extended to corporations is many times the amount associated with the capital stock account.

In a dynamic economy, legal or stated capital of the corporation has little meaning to the creditor. He looks to the earning power of the corporation for his protection and seeks to restrict disbursement of corporate earnings, for his protection, in various ways, e. g., maintenance of working capital at a certain level before payment of dividends can take place, etc. This restriction applies both to the past and future earnings. As long as the restrictions are in force, which is the duration of agreements entered with creditors, the contractual level of capital, which forms the buffer or cushion for the creditors' protection, is different than the capital associated with capital stock. Thus, the creditors reach beyond the veil of the legal concept of capital for their protection.

The importance of earning power as the real protection, rather than a legal "cushion," cannot be overemphasized, for lack of this earning power can result in legal dissipation of the assets which were legally intended to be "frozen" for the protection of creditors.

If maintenance of a certain amount of shareholders' equity, as perma-

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[33]An exception is where collateral is pledged as security for a loan, for example the collateral trust certificate.

nent, is a test for legal capital, then perhaps much can be said for viewing all of shareholders' equity as permanent. One needs to adopt the position that the earnings of the corporate unit are the earnings of the shareholders; the fact that a portion of the earnings is reinvested on behalf of the shareholders indicates their implicit approval. That the implied approval is present is upheld by Hunt, Williams and Donaldson who state:

> In view of the widespread absence or ineffectiveness of shareholder control, the reader may be disposed to conclude that the common shareholder should be considered as just another source of funds along with the bondholder and preferred stockholder. We disagree with this interpretation for two reasons: (1) the common shareholder alone possesses the legal right to control the management and the business, whether he exercises it or not; and (2) the common shareholder continues to bear the fundamental risks of the business, whether or not he dictates its policies. This leads us to the position that questions of financial policy _should_ be determined from the point of view of the interests of the common shareholders existing at the time the policy is being determined.[34]

Since the implied permission is required of the shareholders, the only difference that exists between the reinvested earnings and the amount associated with share capital is that the shareholders are not issued certificates signifying reinvestment. Thus, any future dividend that is in excess of the then current earnings is a liquidating dividend in that the size of the corporate unit is reduced from what it was before.

The legal concept of capital is outdated in that it fails to recognize the necessity of survival of the corporate unit. In a competitive dynamic economy corporations must reinvest a portion of earnings and/or obtain funds from other

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[34] P. Hunt, C.M. Williams, and G. Donaldson, _Basic Business Finance_, (Homewood, Illinois: Richard D. Irwin, Inc., 1958), pp. 457-58.

sources in order to maintain their relative position in that economy. The additional investment, whether from new issues of shares, or reinvested earnings, necessary for the maintenance of relative position in the economy, should be regarded as permanent investment of the shareholders.

Conclusion

The Companies Act, Canada, is preoccupied with the legal concepts of capital and as a result has not yet been relieved of restrictive and outdated provisions dealing with changes in capital subsequent to organization. Therefore the desired flexibility in altering the capital structure of the company is not permitted. Allocation of a portion of the proceeds from a no-par value stock issue to a "Distributable Surplus" account, which is available for dividends is objectionable in that when a dividend is charged to this account, it is a liquidating dividend-return of invested capital to the shareholders. The shareholder, no doubt, had intended that his total contribution form the stated or legal capital of the company, and a return of a portion of this contribution under the guise of a dividend is misleading.

Granting of commissions to purchasers of shares (involving only the issuing company and the purchaser) is an objectionable practice in that no valid service is performed, and commissions, in these cases, are nothing more than a discount on the shares issued. The net result of recognizing commissions as an asset is an overstatement of the assets as well as of the legal capital.

In the Corporations Act, Ontario, the only objectionable provisions with regard to capital provisions are: (1) granting of commissions to purchasers

of shares, and (2) not requiring companies which issued shares prior to April, 1954, to conform to certain provisions of the Act. In the case of commissions, the objections are the same as those cited above. In the case of (2) above, the Act is reduced to a "lame-duck" status and a double standard is set for old and new companies.

The Ontario Act has departed from the "trust fund theory of capital" and from "an inviolable buffer" concept. The Act recognizes that the corporate structure needs to be flexible and that with the agreement of creditors the capital structure can be readily altered. The flexibility with regard to changes of capital structure recognizes the earning power concept.

With regard to the variation of capital subsequent to organization and accounting connected with the variation, the Ontario Act stands out as the most up-to-date in Canadian corporate law.

Finally, in connection with the use of the word "capital," it should be combined with another word to convey the intended meaning. The word, when used alone, should convey more than the amount of the credit in the share capital account, or the value of the tangible assets; it should convey the going-concern value of the enterprise. This view is supported by A. C. Littleton, who states:

> The word "capital" is closer than "asset" to the center of accounting. It tends to direct thought not to the sufficiency of the property in comparison to the debts, but toward property in productive use--property held because it seems to promise to contribute to the creation of revenue. Capital, in the sense of a property that is useful for producing revenue, is a more

nearly basic term for accounting than the word assets used in the sense of property useful for paying debts.[35]

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[35] A. C. Littleton, Structure of Accounting Theory, American Accounting Association, (1953), p. 19.

CHAPTER III

THE CORPORATE SURPLUS

Like many other terms employed by accountants, the legal profession, and in general business usage, "surplus" defies an exact definition which would convey an equally useful meaning to all concerned. In fact, the meaning of the term is so well imbedded in general usage that its use in accounting has been subjected to much misinterpretation by unsophisticated users of financial statements. The misinterpretation has been sufficiently serious to warrant the following statement from a committee of the accounting profession:

> In 1941 the committee suggested a general discontinuance of the term surplus in corporate accounting,. . . Extensive discussion of the proposal followed, and in 1949 it was approved "as an objective" by the committee on accounting procedure. . . . . . In view of the foregoing, the committee in 1949 particularized the proposal which has been so long under consideration by recommending that, in the balance-sheet presentation of stockholders' equity:
>
> (1) The use of the term _surplus_ (whether standing alone or in such combination as _capital surplus_, _paid-in surplus_, _earned surplus_, etc., be discontinued.[1]

[1]Committee on Terminology, _Accounting Terminology Bulletin_ No. 1, American Institute of Accountants, (1953), pp. 28-31.

In 1948 the American Accounting Association dropped the term "surplus" in the discussion of Stockholders' Interest.[2]

In Canada, The Canadian Institute has stated that the usage of the term in accounting is too firmly established and is not likely to be discontinued. The recommendation of the Institute is that the word "surplus" should not be used alone, but should be qualified in every case in which it is used.[3] In addition, the Federal Act refers specifically to "setting aside" a "distributable surplus" Sec. 12 (10) and requires the designation of a "capital surplus" equal to the par value of the redeemed shares in connection with the purchase for cancellation of preferred shares (Sec. 61).

Although the concensus of opinion among accountants is to use other terms in place of "Surplus" there is, however, reservation as to whether the desired end will be accomplished by a mere change in terminology, as evidenced by the remarks of Professors Moonitz and Staehling:

> If knowledge of the contents can be improved by a change in the label on the bottle, well and good. No one can object to such a change. But the contents of the bottle are not altered merely by the adoption of a new label, and too much should not be expected from such a move. Furthermore, none of the new labels proposed thus far is demonstrably superior to conventional terminology. For example, "retained earnings," "earnings reinvested in the business," and "undistributed profits" have all been suggested, or actually employed in published statements. To the accountant, the meaning of these phrases is reasonably clear, but then so is the meaning of "earned surplus." To the layman, the old problem of understanding

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[2] Accounting Concepts and Standards Underlying Corporate Financial Statements, (1948), Rev., American Accounting Association, p. 4.

[3] Committee on Accounting and Auditing Research, Accounting and Auditing Practices Bulletin No. 11, (Toronto: The Canadian Institute of Chartered Accountants, 1955), p. 1.

> still remains; new misunderstandings may develop about the combination of words.[4]

Change in economic values is inevitable in business. Some of this change is brought about by deliberate action of those in charge of the business enterprise, while other changes in value take place in the economic setting in which the business enterprise operates. Whatever the cause, it is desirable or required that these changes be disclosed to the users of financial data. For this reason we are concerned with the accounting for "surplus."

Nature of Surplus. -

The term "surplus" has a restricted meaning as used in accounting and jurisprudence. To many businessmen it suggests a hoard of cash. However, to most it is a balancing figure or a catch-all term used by accountants to bring into balance the assets and the equities. In accounting the term has been variously defined. Accounting Terminology defines surplus as:

> Generally, a remainder or excess. In accounting and finance, a company's surplus is the excess of net assets over the total paid-in par value or stated value of the shares of the company . . .[5]

Kohler defines the term as:

> Stockholders' equity in a corporation in excess of the par or stated value of capital stock: a generic term covering paid-in, earned, and appraisal surplus. . .[6]

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[4]M. Moonitz and C. C. Staehling, Accounting; An Analysis of its Problems (Brooklyn: The Foundation Press, Inc., 1952), Vol. II, p. 121.

[5]Accounting Terminology (Toronto: The Canadian Institute of Chartered Accountants, 1957), p. 71.

[6]E. L. Kohler, A Dictionary for Accountants (Englewood Cliffs: Prentice-Hall, Inc., 2nd Ed., 1957), p. 479.

Smails defines the term as:

> . . . surplus embraces all proprietorship other than that already defined as share capital.[7]

Definitions cited above differ only to the extent of the words used. The latter definition avoids the use of the word "excess" because the primary objection to the term being defined is its misleading connotation of something over and above what is needed or required.[8] All the above definitions are derived from the basic accounting equation of Assets = Liabilities + Shareholders' Equity.

Net Assets = Assets - Liabilities
Shareholders' Equity = Assets - Liabilities
Therefore, Net Assets = Shareholders' Equity
Surplus = Net Assets (Shareholders' Equity) - par or stated value of capital stock (legal capital)

Recent publications avoid defining "surplus";[9] the authors prefer to concentrate on classifying "surplus" on the basis of the nature of the accounting

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[7]R. G. H. Smails, Accounting Principles and Practice, (Toronto: The Ryerson Press, Rev. Ed., 1954), p. 305.

[8]Ibid., p. 305.

[9]Among the textbooks which discuss surplus without defining the term are: Wm. A. Paton, Essentials of Accounting (New York: The Macmillan Co., Rev. Ed., 1949); A. W. Holmes, G. P. Maynard, J. D. Edwards and R. A. Meier, Elementary Accounting (Homewood: Richard D. Irwin, Inc., Rev. Ed., 1956); P. Mason, A. Davidson, J. S. Schindler, Fundamentals of Accounting (New York: Henry Holt and Co. Inc., 4th Ed., 1960); R. R. Milroy and R. E. Walden, Accounting Theory and Practice, Introductory (Cambridge: Houghton Mifflin Co., 1960); M. Backer, Editor, Handbook of Modern Accounting Theory (New York: Prentice-Hall, Inc., 1955).

entries which led to the existence of the account. In other words, the authors are of the opinion that comprehension can better be accomplished through the differentiation of sources, rather than by definition of the term "surplus."

The meaning of "surplus" in law is apparently in agreement with the meaning in accounting. This is attested to by the pronouncement of Justice Brandeis who stated:

> The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock.[10]

Professor Sidney I. Simon, in his article "Legal Decisions on the Accounting for Corporate Surplus" states:

> . . . the legal understanding of surplus is very much akin to that of the accounting definition. The courts have paid a tremendous amount of attention to the whole question of surplus, earnings, and dividends, and certainly accept the technical meaning of the word, rather than any colloquial connotation.[11]

Source of Surplus. -

The usual classification of corporate surplus is by origin and these sources are generally combined into three broad groupings: (1) Contributed or paid-in surplus, (2) Earned surplus, and (3) Revaluation or appraisal surplus. The first, of the above groupings, covers the largest number of elements. Professor Byrd includes the following sources in the "contributed surplus" grouping:

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[10]Edwards v. Douglas, 269 U.S. 204, at 214, 1925.

[11]Sidney I. Simon, "Legal Decisions on the Accounting for Corporate Surplus," The Accounting Review, XXXI (January, 1956), p. 105.

(A) Surplus resulting from transactions in the company's own stock:

(1) Premiums on par value stock.

(2) Excess of amounts received for no-par stock over amounts set up as stated values thereof, termed "distributable surplus" in section 12 (10) of the Companies Act, Canada, 1952.

(3) Forfeited part payments on stock subscriptions.

(4) Surplus resulting from miscellaneous stock transactions and changes:

(a) Sales of treasury stock at more than cost, but such stock is not normally legal in Canada.
(b) Retirement of stock at a cost less than the amount set up as stated capital.
(c) Conversion of stock of another kind.
(d) Reduction of stated capital.

(B) Surplus resulting from shareholders' contributions:

(1) Donations by shareholders, including gifts and forgiveness of indebtedness.

(2) Assessments of shareholders.

(C) Surplus 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.[12]

The primary implication of the term surplus is net income not distributed to the shareholders, that is "earned surplus." The source of "earned surplus" is the profitable operation of the enterprise. "Earned surplus" includes realized net gains on disposition of fixed assets, income from investments and such extraordinary items as correction of periodic net income of prior years. There is a divergence of opinion on the classification of the item

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[12]Illustrations adapted from H. A. Finney and H. E. Miller, Principles of Accounting, Intermediate, Canadian Edition, prepared by K. F. Byrd (Englewood Cliffs, 1959), p. 128.

"forgiveness of indebtedness." Professor Byrd classifies "forgiveness of indebtedness" as a "contributed surplus," but the Canadian Institute of Chartered Accountants and Professors Wixon and Kell classify "forgiveness of indebtedness" as "earned surplus."[13] If a debtor were allowed to settle his indebtedness for a smaller consideration as a result of defective quality of the consideration which created the indebtedness or similar reasons, a purchase discount is received and the accounting treatment recognizes the amount that was "forgiven" as "earned surplus" through the intermediary of the debtor's income statement. However, the term "forgiveness of indebtedness" seems to refer to a partial or complete forgiveness of indebtedness because of inability of the debtor to pay. In this latter case Professor Byrd's treatment is a more reasonable one, that is a contribution from an outside party.[14] The fact that the "contribution" was not voluntary should not detract from the basic nature of the transaction.

Revaluation surplus arises primarily as a result of a rising price level and the desire of the company to adjust the book value of fixed assets to the

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[13]Committee on Accounting and Auditing Research, op. cit., p. 2, and Rufus Wixon and W. G. Kell, Editors, Accountants' Handbook (New York: The Ronald Press, 4th Ed., 1956), p. 228.

[14]To illustrate assume that company D owes company C $40,000 and that D is unable to pay the account. If company C puts company D into bankruptcy the proceeds to company C from liquidation may be small, if any, and C would lose a customer for its products. As an alternative, a settlement is reached whereby company C "forgives" $20,000 of the amount owing by company D in order that company D may continue in business and continue to buy from company C. The $20,000 representing the amount "forgiven" would be a contribution to company D from company C and not part of earned surplus.

current value of these assets. Current value is usually determined by having an outsider appraise the fixed assets. The excess of the appraised value over book value constitutes the "revaluation surplus" which is an unrealized increment as opposed to "earned surplus" which has been realized.

Surplus in Canadian Corporation Law

The legal provisions deal with both the designation of surplus and the disclosure of surplus. These provisions are as follows:

<u>The Companies Act, Canada</u>

Section 12 (10)

> In the absence of other provisions in that behalf in the letters patent, supplementary letters patent or by-laws of the company, the issue and allotment of shares without nominal or par value may be made from time to time for such consideration as may be fixed by the board of directors of the company; and in fixing the amount of such consideration, the board, subject to the provisions of this Part, may provide in the contract of subscription for such shares that the consideration received therefor shall be deemed to be capital, excepting a part, if any, not exceeding twenty-five per cent thereof, that may be set aside as distributable surplus; and where the company acquires a going concern that has a surplus over and above all liabilities, and any shares without nominal or par value in the company are issued and allotted as fully paid in payment or part payment for such going concern, the directors may by resolution set aside, as a distributable surplus, such part of the consideration for the issue and allotment of such shares without nominal or par value as does not exceed the unappropriated balance of realized net profits of the going concern immediately before such acquisition.

Section 61

> . . . redemption or purchase, in accordance with the provisions of such letters patent or supplementary letters patent, or by-laws, shall not be deemed to be a reduction of the paid-up capital of the company . . .. and the surplus resulting from such redemption or purchase for cancellation shall be designated as a capital surplus, which shall not be reduced or distributed by the company except as provided in sections 49 to 58.

Section 116 (c)

> . . . a statement of surplus showing separate accounts for capital surplus, distributable surplus and earned surplus respectively, the amounts of such surpluses respectively at the beginning of the financial period, adjustments affecting previous financial periods, net profit or loss as shown by the statement of income and expenditure, dividends paid or declared on each class of shares stating the account against which the same are charged, any other appropriations, changes in and balance remaining of capital surplus, distributable surplus and earned surplus respectively.

Under the Companies Act, Canada, "surplus" arises from designating a portion (up to 25 per cent) of proceeds from issuance of no par shares; "surplus" carried over from an acquired going concern; "surplus" as result of issuance of par shares for an amount in excess of par, and; "surplus" arising from permanent "freezing" of retained earnings on redemption of preferred shares. Although in practice other sources of surplus are found, e.i., donated surplus, the Act does not specifically refer to these other sources.

The Corporations Act, Ontario

Section 85

> (1) Every statement of surplus shall be drawn up so as to present fairly the transactions reflected in such statement and shall show separately a statement of contributed surplus and a statement of earned surplus.
>
> (2) Every statement of contributed surplus shall be drawn up so as to include and distinguish the following items:
>
> 1. The balance of such surplus at the end of the preceding financial period.
>
> 2. The additions to and deductions from such surplus during the financial period including,
>
>   (a) the amount of surplus arising from the issue of shares or the reorganization of the company's issued capital, including inter alia,

(i) the amount of premiums received on the issue of shares at a premium,
(ii) the amount of surplus realized on the purchase for cancellation of shares; and

(b) donations of cash or other property by shareholders.

3. The balance of such surplus at the end of the financial period.

(3) Every statement of earned surplus shall be drawn up so as to distinguish at least the following items:

1. The balance of such surplus at the end of the preceding financial period.

2. The additions to and deductions from such surplus during the financial period and without restricting the generality of the foregoing at least the following:

(i) The amount of the net profit or loss for the financial period.

(ii) The amount of dividends declared on each class of shares.

(iii) The amount transferred to or from reserves.

3. The balance of such surplus at the end of the financial period. 1953, c. 19, s. 85.

No provisions are found in either Act with regard to writing up of asset values to their appraised values.[15]

The specific provisions of the two Acts dealing with surplus are similar only on the subject of disclosure. Both Acts require a statement of surplus on each balance sheet date, showing the sources of its various components as well

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[15]The only reference to appraisal surplus is found in Section 83 (2) of the Federal Act. This section permits the charging of dividends to an appraisal surplus five years after the appraisal was effected.

as the changes in each class of surplus since the previous statement. A notable departure of the present Ontario Act from both the old Ontario Act and the present Federal Act is that no "surplus" arises in connection with the issuance of no par shares. The total consideration for no par shares is required, by the Ontario Act, to be credited to the capital stock account. The Federal Act permits, at the discretion of the directors, the designation of up to a maximum of 25 per cent of the issue consideration as "Distributable Surplus." (See examples Chapter II, p. 18). The Federal Act prescribes that the "Distributable Surplus" caption be used for the excess of consideration over the stated value.

The "Distributable Surplus," as the caption implies, is unrestricted and dividends may be charged to this account, presumably when no balance exists in the retained earnings account. Other "surplus" accounts (with the one exception of "Surplus" arising under Section 61 of the Federal Act), such as premium on shares, donations by shareholders or outsiders, purchase of shares for cancellation at less than par, or stated value, etc., are similarly unrestricted and can be utilized in connection with dividend declaration. This is true also of "appraisal surplus" five years after the writeup of the assets for companies incorporated under the Federal Act.

Surplus arising under Section 61 of the Federal Act is restricted. The amount of this "surplus" is equal to the par value of the preferred shares purchased and cancelled. The intention of the provision is to maintain the legal capital after purchase and cancellation of preferred shares at the level prior to the cancellation. This "surplus" required by law to be designated as "capital surplus" can be reduced only by following the procedure set out in sections 49 to 58 in the Federal Act for the reduction of legal capital.[16] (For discussion of these sections see Chapter II, p. 25).

The two Acts are distinct in the provisions which deal with forfeited shares. Under the Federal Act if the forfeited shares are disposed of for an amount in excess of the due amount on these shares, the excess is retained by the company (Federal Section 43 2) and is a source of a contributed surplus. Under the Ontario Act if the amount received for the forfeited shares is in excess of the amount due on these shares, the company must return the excess to the subscriber who forfeited the shares (Ontario Section 53 7).

Both Acts provide that the subscriber who forfeited the shares continues liable to the company and to its creditors for the full amount unpaid on such shares at the time of forfeiture, less any sums that are subsequently received by the company on disposal of such shares (Ontario Section 53 6) Federal Section 43 3). Nothing is stated, with regard to the liability of the subscriber who forfeited the shares, if the company cancelled the forfeited

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[16] With regard to Section 61 (Federal Act), G.R. Horne stated: "Retirement of preferred stock requires the setting up of a 'capital surplus' equal to the par value of the shares being retired (Sec. 61 of The Dominion Companies Act, 1934). On the following annual meeting of the shareholders, the amount may be returned to earned surplus, if authorized by the shareholders . . . the law permits the defeating of the supposed purpose of Sec. 61, which aims at replacing the retired preferred stock with a permanent surplus account." G.R. Horne, <u>The Receivership and Reorganization of the Abitibi Power and Paper Company, Limited</u> (Ann Arbor: University Microfilms, 1954), p. 343, footnote 112. Of course, the same reasoning could be applied to the implication of legal capital as permanent capital, since it too can be reduced by the same procedure (Federal Act, Sections 49-58).

shares, which is apparently within their power as set out in the Federal Act Section 43 (2) as follows:

> Such shares so declared forfeited thereupon become the property of the company, and, subject to any provisions of the by-laws of the company, may be sold or otherwise disposed of in such manner as the directors think fit.

The Ontario Act is not clear on whether the forfeited shares may be cancelled. Section 53 (5) states:

> Any forfeited shares become the property of the company upon forfeiture, and, subject to its by-laws, may be sold.

Both Acts require classification by source of the items which constitute "corporate surplus." This conforms to the recommendations as set out by The Canadian Institute.[17]

Reconsideration of Surplus Items

<u>Premium on Issued Shares--Preferred</u>

When par value preferred shares are issued for a consideration in excess of the par value of the shares, the excess constitutes a premium on the issued shares. This premium arises not because of a superior credit rating of the issuing company, but because the dividend rate is in excess of the then market yield rate for the given quality of preferred shares. To illustrate, assume that company ABC desires to raise $100,000 through a preferred share issue. The market demands a 6% yield on ABC Company's preferred shares. The Company desires that the par value of the shares be $20 each.

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[17]Committee on Accounting and Auditing Research, <u>op. cit</u>.

Two alternatives are open to the company:[18]

(1) The company may choose to issue 5,000 6% $20 par value shares, or

(2) The company may choose to issue fewer than 5,000 shares of $20 par with a higher than 6% dividend rate.

If the first alternative is chosen, 5,000 shares would be issued at par since the required market yield rate for this quality of shares is equal to 6 per cent which is also the yield at par on the shares being issued. One hundred thousand dollars would be raised and the annual dividend requirement would be $6,000 (5,000 x $1.20). If the second alternative is chosen, assuming that 7 1/2% dividend rate is established on par, the preferred shares must sell at a premium, because the market demands only a 6% yield on these shares. The issue price will then be $25 per share and the company will need to issue only 4,000 shares to raise the required $100,000. The annual dividend requirement will, however, be the same as in the first alternative, that is $6,000 (4,000 x $1.50).

The legal capital of the company would be increased by $100,000 with the former alternative and by $80,000 with the latter alternative. The difference of $20,000 is the premium on the issued preferred shares and would be classified as contributed surplus. Since the contributed surplus is part of common shareholders' equity, $20,000 of the proceeds of the preferred share issue was in effect diverted from the preferred shareholders' equity to the common share-

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[18] In jurisdictions where shares can be legally issued at a discount a third alternative is open to the company--that of issuing more than 5,000 shares in the above examples of $20 par value with a lower than 6% dividend rate.

holders' equity. The above view prevails as long as preferred shares are not regarded as debt capital or as having a maturity date. If, however, the view adopted is that preferred shares are debt capital and/or have a maturity date, then the premium or discount, where allowed, should be regarded as an adjustment of the "dividend" rate. However, as long as preferred shares are regarded as perpetual ownership equity then diversion of preferred shareholders' equity is a highly questionable practice, both from the accounting and ethical points of view. The law purports to protect the rights of the suppliers of capital, yet permits such a "parasitic" practice.[19]

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[19] The "parasitic" practice is illustrated by Professor H. D. Lowe in "The Classification of Corporate Stock Equities." In his example Professor Lowe states that the XYZ Company has an authorization to issue 1,000 shares of $100 par value preferred stock and 40,000 shares of common stock par value $10. Subsequently, at different times the company issues 600 preferred shares at $105 and 400 at $96 and 12,000 common shares at $23 per share. In the Shareholders' Equity section of the balance sheet (First Illustration) the following appears:

Invested Capital		
Legal Capital:		
Preferred Stock, $100 par value, 1,000 shares authorized and issued legal amount	$100,000	
Less deficiency of investment contribution on 400 shares	1,600	
		$98,400
Common Stock, 40,000 shares authorized, 12,000 shares issued legal amount		120,000
		$218,400
Paid-in Capital in Excess of legal requirements		159,000
Total Invested Capital		$377,400

Professor Lowe appears to be unconcerned with the "parasitic" practice. He adds the premium on the preferred shares to the premium on the common shares while deducting the discount on the preferred shares from the par or

On the treatment of premium on preferred shares, Paton and Paton state:

> There has been some controversy regarding the treatment of the excess over par paid by preferred shareholders. The question is: should such excess be reported as a part of the equity of the senior stock or should it be regarded as attaching to the common stock, in combination with any excess over par paid in by the junior shareholders? The position is taken here that it is the business of the accountant to report clearly and separately the amount invested by each class of investors.[20]

Labelling the amount received from preferred shareholders as "Capital received from preferred shareholders--par" and "Capital received from preferred shareholders--amount in excess of par" may be satisfactory to accountants; however, it does not remedy a basically unsound practice permitted by law. The basically unsound practice is regarding the premium on preferred shares as a "surplus" against which dividends to common shareholders may be charged.

Investment in Excess of Par or Stated Value

Creation of no par shares, leaving the directors to designate the amount of legal capital, has given rise to what may be referred as "flexible par value."

In essence there is no difference between par value and stated value.

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legal amount. He fails to draw a clear distinction between the investments of the two classes of shareholders.

Howard D. Lowe, "The Classification of Corporate Stock Equities," The Accounting Review, XXXVI (July, 1961), pp. 427-28.

[20]Wm. A. Paton and Wm. A. Paton, Jr., Corporate Accounts and Statements (New York: The Macmillan Co., 1955) p. 81.

The former is set by law at the time authorization takes place, while the latter is set by corporate by-law or by resolution of the directors. A subsequent change in par must be approved by a stipulated percentage of the shareholders and sanctioned by the incorporating authority. A subsequent change in stated value is effected by corporate by-law or by resolution of the directors. The usual restriction pertaining to the stated value is that stated capital must be a certain percentage of the consideration for the issued shares, e.g. The Companies Act, Canada, (Sec. 12 10) specifies a minimum of 75 per cent, while the Michigan statute specifies a minimum of 50 per cent.[21]

The excess of the consideration over par or stated value, whether captioned as premium, paid-in capital, capital surplus, or distributable surplus, permits a company to begin operations with a "surplus." This tends to give the company an immediate semblance of strength which has not been proven and which may never materialize.

The often used argument in favour of designating part of the invested funds as "surplus" on the ground that the creditors are put in a better position because this "surplus" can be used to absorb losses without impairing the legal capital is weak.

Paton points out:

> If losses of invested funds are suffered the hardship to stockholders is not minimized by the practice of setting up the proceeds of the capital stock when issued in two sections, one of which is viewed as a form of surplus. Neither does this practice render the position of the creditor any more secure as it does not affect

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[21] <u>Ibid.</u>, p. 16.

the size of the "cushion" which affords him protection.[22]

Hatfield's comment on this is:

This is true but not significant. The creditors are not better protected but they are notified in advance that they cannot definitely count on the entire contributions by the stockholder, but only on the amount shown as stated capital.[23]

Both parts of Hatfield's comment do not invalidate the significance of Paton's statement. No doubt the creditors would be better notified by showing an impairment of capital rather than by burying or hiding the extent of the impairment. Consider the following illustration: Assume in case A that the total consideration for issued shares was credited to the capital stock account and in case B only 75 per cent was credited to the capital stock account; assume a first period operating loss of $30,000:

Example I

Case A Partial Balance Sheet:

Stated capital	$200,000	
Deduct: Deficit from operation	30,000	$170,000

Case B Partial Balance Sheet:

Stated capital	$150,000	
Paid-in surplus	20,000	$170,000

The Balance Sheet in Case A would be a better indicator or warning to creditors

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[22]Wm. A. Paton, Advanced Accounting, (New York: The Macmillan Co., 1941), p. 524.

[23]H. R. Hatfield, Surplus and Dividends (Cambridge: Harvard University Press, 1947), p. 15.

of the risk involved in the situation than in case B. This would be true especially where new creditors extended credit on the basis of examining only the latest available balance sheet.[24]

The second part of the argument: that the creditors can definitely count on only the amount shown as stated capital, is not valid. Impairment of the stated capital can take place as illustrated in the following example: Assume the facts as given above for Case B, except that the operating loss is $80,000.

Example II

Case B Partial Balance Sheet:

Stated capital	$150,000	
Deficit from operation (amount not absorbed by paid-in surplus)	30,000	$120,000

The impairment of capital as shown is legal though involuntary. The "cushion," even if measured only by the amount of stated capital, has been reduced from $150,000 to $120,000.

Dewing's concluding remark in a similar situation, which is applicable to the above discussion, is: "This is a difference of psychology, and not of logic."[25]

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[24]It is true that Sec. 116(c) of the Federal Act and Sec. 85 of the Ontario Act require disclosure of changes in Surplus. However, the Acts require disclosure only in the year the change takes place; no reference need be made in subsequent years. Disclosure of changes in surplus is shown in the Surplus Statement only.

[25]A. S. Dewing, Financial Policy of Corporations (New York: The Ronald Press Company, Fifth Ed., 1953), p. 670.

Donated Surplus

Situations occur when donations are made to a corporation by outsiders or by the shareholder(s) of the corporation. Problems which are associated with donations are primarily those of valuation of the donation and recognition of the donation on the books of the company.

In general, if donations are in form other than cash, the valuation procedure should be the same as when shares are issued for a consideration other than cash. The value is usually determined by the directors and at times with the help of outside appraisers. (Problems arising in connection with valuation of considerations other than cash for the corporation's share are discussed in Chapter II p.22). The criterion for recognition of donations on the books should be value.[26] If a donation exists, standards of full disclosure in accounting dictate the recognition of the donated assets on the books of the corporation.

Recognition of the donation on the books would appear as follows:

Asset (Land, buildings, etc.)	XXX	
Donated Surplus[27]		XXX

At times donations are granted subject to the fulfillment of certain conditions, e.g., title of the land will pass over to the company on completion of the twentieth year of operation in the particular location. The fact that the

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[26] W. J. Vatter suggests better terminology for "Donated Surplus" is "Contributions from Non-Stockholders." Morton Backer, (Editor) Handbook of Modern Accounting Theory (New York: Prentice-Hall, Inc., 1955), p. 380.

[27] If the donation received has no value to the company or no resale value then no donation exists.

company may not operate for the required period in the location, and the title of the land may never rest with the company, should not govern whether recognition should or should not be made on the books. The determining factor should be value at the time of the donation.[28] If the company abandons the location before the title passes, accounting treatment would be the same as abandoning a location on which title was held.

If the donation is in depreciable assets, accounting for the depreciable asset should be the same as if the asset were purchased. This is required if proper income determination is to be accomplished.

Before the advent of no-par shares, wide use was made of donating shares back to the corporation as a means of circumventing legal provisions prohibiting the issuance of par shares at a discount, but permitting the reissue of donated treasury shares. An example of this would be the issuance of 10,000 $10 par value shares for an asset with nominal value of $100,000 other than cash with a provision that 5,000 of these shares will be "donated" back to the company. The company is at liberty to issue these "donated" or treasury

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[28] Finney and Miller favour recording conditional donations in temporary accounts until the contractual conditions are met, at which time these accounts are closed out to conventional fixed assets and paid-in surplus accounts. Finney and Miller, Principles of Accounting, Intermediate (New York: Prentice-Hall, Inc., 4th Ed., 1951). Newlove and Garner are of the opinion that only unconditional gifts are to be recorded. G. H. Newlove and S. P. Garner, Advanced Accounting (Boston: D. C. Heath and Co., 1952).

The objection to the Finney and Miller recommendation is that many of the assets acquired by the corporation are subject to the fulfillment of certain stated conditions, such as payment of mortgages, yet these assets are recorded in permanent accounts. The recommendation of Newlove and Garner is objected to (1) from the disclosure point of view and, (2) from the income determination point of view in the case of depreciable assets. Net Income would be overstated by the amount of unrecognized depreciation.

shares for less than par as fully paid. The basic weakness is permitting the corporation to trade in its own shares. Donation of the corporation's shares to the corporation enhances the value of the remaining outstanding shares, but adds nothing to the corporate assets. If the "donation" was made by only a part of the shareholders, or was not pro-rata, the donation of anything of value is to the shareholders who did not participate, or who did not participate ratably in the donation. A pro-rata "donation" of shares is nothing more than a stock-split in reverse. The assets remain unchanged, shareholders' equity remains unchanged, and the number of claims of shareholders (number of shares) decreases in inverse proportion to the change in value of these claims.

Donations other than the corporation's own shares should be recognized on the books in the same manner as donations from outsiders.[29]

Surplus from Forfeited Shares

When a shareholder of partially paid shares fails to pay the amount demanded by the company, the company may declare the shares forfeited and the partially paid shares become the property of the company. When these shares are re-issued for an amount in excess of the amount which was due on these shares at the time of forfeiture, and where the excess amount is not required by law to be returned to the shareholder who forfeited the shares, a contributed surplus equal to the excess amount is recognized on the books of the company.[30]

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[29]Voluntary stock assessments on fully paid shares should also be recorded in the same manner as donations.

[30]W. G. Leonard and F. N. Beard stated: "If the forfeited shares are sold, the sale price is set up as a debit balance in the Subscribers account, the entries in the Forfeited Shares and Forfeited Shares Suspense accounts are re-

The implication is that the company receives a valuable property when partially paid shares are declared forfeited. The question that arises is that if fully paid shares in the possession of the company (treasury shares) are not assets,[31] how can partially paid shares become assets of the company? It is not the forfeited shares per se which have value, but the claim against the subscriber.

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versed, and any excess of the sale price over the unpaid balance on the shares is treated as a profit." W. G. Leonard and F. N. Beard, Canadian Accounting Practice (Toronto: McGraw-Hill Company of Canada Limited, 1956), p. 328.

To refer to the excess amount as a profit, is to sanction the inclusion of the amount in the income statement, a practice which is not consistent with the nature of the transaction and has no theoretical basis in accounting. To permit this practice is indeed a backward step in accounting theory and practice.

To illustrate recognition of "profit on forfeited shares" assume: A subscribed to one share of stock for $10; after paying $4 A fails to pay future "calls" and forfeits the share of stock; the company reissues the share of stock for $9 to B.

Subscriptions Receivable from A	$10		
Share Capital subscribed		$10	
To record subscription of one share of stock at $10 by A			
Cash		$ 4	
Subscriptions Receivable from A			$4
To record receipt of $4 from A representing Call No. 1			
Forfeited Shares		$ 6	
Subscriptions Receivable from A			$6
To record forfeiture of one share of stock by A on failure to meet Call No. 2.			
Cash		$ 9	
Forfeited shares			$6
Profit on sale of Forfeited Shares			$3
To record sale of one share of forfeited stock to B for $9 cash			

[31] Rufus Wixon and W. G. Kell (Editors) Accountants' Handbook (New York: The Ronald Press Co., 4th Ed., 1957), p. 21.33.

Logical treatment would dictate that after the company has taken due process, legal if necessary, to collect the amount due on these shares, when collection cannot be effected the deposit paid to date should be declared forfeited and the subscriptions related to these deposits cancelled.

Revaluation Surplus

One of the most controversial problems in accounting, in recent years, has been the effect of inflation on the ability of the dollar to measure income. Although in recent years the controversy has subsided somewhat, the problem remains. The intention here is not to consider the problems associated with income measurement, but rather with the disposal of "surplus" arising from upward revisions of asset figures due to price level increases. On the subject of appraisal the American Institute voiced the following opinion:

> Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values is both impracticable and inexpedient.[32]

The same body retreated slightly in the position taken earlier by stating the following in connection with depreciation:

> The Committee . . . believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level. An attempt to recognize current prices in providing depreciation to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by

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[32]Committee on Accounting Procedure, Accounting Research Bulletin No. 5, (New York: American Institute of Certified Accountants, 1940).

> by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.[33]

The Canadian Institute has taken a similar position:

> Fixed assets are normally accounted for on the basis of their historical cost and in recent years accounting organizations have re-affirmed the emphasis on historical cost by refusing to recommend depreciation on current replacement cost in formal accounts. Unless replacement cost accounting becomes generally acceptable, the writing up of fixed asset values should not occur in ordinary circumstances and should be discouraged.[34]

Notwithstanding the recommendations of the two accounting organizations, the accounts of some enterprises have been adjusted to reflect fixed asset valuations based upon appraisals. Where revaluation of fixed assets has been accomplished The Canadian Institute recommends that the amount resulting from such revaluation not be referred to as "surplus."

> . . . In view of the committee the designation of any such amount as an appraisal surplus or reserve is undesirable. One suitable designation for an appraisal increase would be "Excess of appraised value of fixed assets over cost" (or "over depreciated cost").[35]

The recommendation for subsequent treatment is:

> Once recorded the appraisal increase may remain indefinitely as a separate item in the shareholders' equity section of the balance sheet, or it may be transferred to earned surplus in

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[33]Committee on Accounting Procedure, Accounting Research Bulletin

[33]Committee on Accounting Procedure, Restatement and Revision of Accounting Research Bulletins, Bulletin No. 43, (New York: American Institute of Certified Accountants, 1953), p. 68.

[34]Committee on Accounting and Auditing Research, op. cit., p. 3.

[35]Ibid., p. 3.

amounts not exceeding the realization of appreciation through sale or annual depreciation provisions.[36]

The alternative permitting the transfer of the realized portion of appreciation fails to distinguish the three sources of "capital": investment (legal capital), retained earnings, and debt. Recognition of equity rights would dictate that appreciation resulting from price level changes should be recognized in three categories. These are: (1) amount resulting from "investment" of creditors, (2) amount resulting from investment by shareholders--legal capital, and (3) amount resulting from reinvestment of earnings.[37] As realization of appreciation takes place through sale or annual depreciation provisions, appropriate amounts would be recognized in retained earnings, legal capital, and "donations from creditors." The last item would measure the amount "contributed" to the enterprise through loss of purchasing power of the creditors. The transfer to the legal capital account, or to a subdivision thereof would keep the "cushion" intact.[38] Retained earnings against which

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[36]Ibid., p. 3. The recommendation of the Canadian Institute of Chartered Accountants disagrees with the opinion of the American Institute of Certified Public Accountants only to the extent of disposal of the "excess over cost" amount. The American Institute in Bulletin No. 43, Chapter 9, states: "A company should not at the same time claim larger property valuations in its statement of assets and provide for the amortization of only smaller amounts in its statement of income."

[37]The appropriate amounts should be determined by the use of a weighted average.

[38]If revaluation takes place and the appraisal amount is transferred, as realized, to retained earnings, the reduction of the "cushion" would be to the same extent, in terms of purchasing-power, as if no recognition took place. If the present tax system remains in effect, retained earnings under both alternatives would approach equality when an extended period of time is considered. In the following illustration (Period 1a) if the appraisal increment is realized

dividends are charged would increase only by an amount resulting from the effect of price level change applicable to the reinvestment of prior years' earnings. The only real "surplus" that accrues to the company, measured in terms of purchasing power, is the sacrifice in purchasing power that the creditors make. To illustrate consider the following:

Period 1

Assets		Equities	
Fixed Assets	$200,000	Funded Debt	$50,000
		Shareholders' Equity:	
		Share Capital	50,000
		Retained Earnings	100,000
	$200,000		$200,000

Assume in Period 2 Fixed Assets are written-up to appraised values:

Period 2 (Usual balance sheet treatment)

Assets		Equities	
Fixed Assets	$400,000	Funded Debt	$50,000
		Shareholders' Equity:	
		Share Capital	50,000
		Retained Earnings	100,000
		"Excess of Appraised Value"	200,000
	$400,000		$400,000

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retained earnings will be increased by $200,000; however share capital which represents "legal capital" or the "cushion" would be only one half of what it was in example (Period 1) as a result of the doubling of the price level.

Period 2 (Proposed balance sheet treatment)

Assets		Equities	
Fixed Assets	$400,000	Funded Debt	$50,000
		Shareholders' Equity:	
		Share Capital	50,000
		Retained Earnings	100,000
		"Excess of Appraised value" to be converted to contributed "surplus" by creditors as result of loss in purchasing power as realization takes place	50,000
		"Excess of Appraised value of Fixed Assets" to be converted to Share capital as realization takes place	50,000
		"Excess of Appraised value of Fixed Assets" to be converted to Retained Earnings as realization takes place	100,000
	$400,000		$400,000

The use of the term "surplus" is therefore undesirable in describing appraisal increments. The caption recommended by The Canadian Institute, "Excess of appraised value of fixed assets over cost" or some other descriptive term should be used.

Earned Surplus[39]

Accountants, for many years, have taught that it is important to account for the ownership equity in terms of origin, with particular emphasis on an

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[39]Determination of periodic net income and charges to retained earnings are discussed in Chapter VI, "Disclosure of Corporate Activity." Capitalization of retained earnings is discussed in Chapter IV, "Dividends." The problem of surplus on merger or consolidation is discussed in Chapter V, "Mergers and Consolidations."

accurate statement of earned surplus.[40] The concern with earned surplus is not only prompted by legal requirements but the dependence of the earned surplus amount on the periodic income determination and the magnitude of the amount in relation to other sources of corporate assets.[41]

The primary legal interpretation of earned surplus has been that it serves as a measure to limit disbursements of corporate funds to shareholders as dividends in order that the "cushion" may be maintained intact for the protection of creditors. The legal significance of this interpretation has tended to decline for two principal reasons. These are: (1) legalizing companies to designate a part of the consideration received for issued shares as some type of "contributed surplus" against which dividends may be charged, and (2) the tendency to regard earned surplus as permanent, by financial administrators.[42]

Regardless of statutory requirements, or legal interpretation, to accountants earned surplus represents the accumulated undistributed profits of a corporation from whatever source derived. A negative interpretation of earned surplus has been stated as follows:

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[40]Samuel J. Broad, et al, "A Symposium--Is it Desirable to Distinguish between Various Kinds of Surplus?" The Journal of Accountancy LXV (April, 1938), pp. 281-292.

[41]Corporate retained earnings and depletion increased by $98.7 billion in the ten-year post-war period (1946-1956), Pearson Hunt, C.M. Williams and Gordon Donaldson, Basic Business Finance (Homewood: Richard D. Irwin, Inc., 1958), p. 527.

[42]Paton and Paton are of the opinion that "It is much nearer the truth, typically, to insist that the retained earnings balance, like the capital received directly from shareholders, is embedded in a cross-section of all the resources, and thus is a part of the total permanent investment." W.A. Paton and W.A. Paton, Jr., op. cit., p. 121.

> . . . contributions to a business and amounts earned in the conduct of the business are the only sources of realized surplus. Consequently, whatever surplus may not be included under the heading contributed surplus must come under that of earned surplus and be so classified on the balance sheet.[43]

Viewing earned surplus as a "catch-basin" tends to convey an idea that earned surplus is not determinable independently and is to be avoided. Earned surplus is a determinable amount and should be so viewed.

Subdividing earned surplus into so-called "Equity reserves" (appropriated earned surplus), is a practice that should be discouraged. In most cases these "reserves" serve no useful purpose, in fact, they tend to mislead users of financial data. This temporary "freeze" of earned surplus is no "freeze," since in most cases these "reserves" may be "freed" or returned by the directors and in fact are voluntary restrictions imposed by the directors on themselves which they, the directors, can rescind at will. Restricted reserves (reserves required by contract) such as sinking fund reserves usually lack significance because the restricted portion is small in relation to the unrestricted portion of the retained earnings. If it is necessary to restrict the directors, a more effective method should be used such as restriction of items appearing, or which will appear, on the asset side of the balance sheet. Earned surplus is a "reserve" in itself and should remain intact as one amount on the balance sheet. The assets are not restricted to correspond with the "reserves" that may be established for any specific purpose. They remain unrestricted and devoted to the general purpose of the corporation and "reserves," as such,

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[43]H. A. Finney and H. E. Miller, Canadian Edition, op. cit., p. 130.

have no basic foundation nor do they serve a useful purpose.

A former president of The American Institute of Certified Public Accountants has made the following pronouncement regarding "reserves":

> Our profession should take the lead in educating businessmen and the general public that the surplus account itself is the real reserve for contingencies and should be conserved to whatever extent is deemed necessary. We should also point out that the desire of the business management to husband resources to meet contingencies cannot be accomplished by a balance on the liability side of the balance-sheet, either in the contingency reserve or in surplus, but that the resources to be effective must be in the form of cash or marketable securities.[44]

Summary

There are primarily two reasons for misinterpretations of "corporate surplus." These are: (1) misleading terminology and, (2) unsound accounting practices. In connection with paid-in "surplus," "distributable surplus," "premium on issued shares" or any other such term W. J. Vatter states:

> . . . If there must be a difference between legal capital and financial or accounting capital (which is the amount of stockholder investment) the least that should be done is to call the difference what it is: "stockholder contributions in excess of legal minimum."[45]

The use of descriptive terminology would solve many of the problems in misinterpretation of donations, reinvestment of prior years' earnings, and retirement of stock at a cost less than the amount on the books. The use of descriptive

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[44]C. O. Wellington, "Accounting for Contingency Reserves," Journal of Accountancy, LXXXIV (August, 1947), p. 104.

[45]Morton Backer, (Editor), op. cit., p. 375.

terminology does not, however, correct unsound accounting practice in recording the consideration received for issued shares of one class in more than one account. The solution to this is prescribed by Paton and Paton who state:

> . . . The cure lies in the outright abandonment of all arbitrary stated capital requirements and the acceptance of the view that corporate capital is represented by the total amount invested by the stockholders.[46]

W. J. Vatter concurs stating:

> . . . The concept of stock without par value would appear to have been an excellent basis for identifying and unifying investment contributions with the legal capital requirement.[47]

Adoption of the above recommendations would, to a large extent, solve the problems arising in connection with contributed surplus. The ridiculous nature of the problem is best summarized by H. R. Hatfield:

> There are those who stoutly maintain that capital surplus is part of capital, emphasizing the first word of the phrase. Others assert that the noun is the significant word and that capital in its adjectival use merely describes the kind of surplus presented. Those who assert that capital surplus is not really surplus because of the modifier are following the pattern of using the phrases "German Silver," "French Ivory," and "Welsh Rabbit" to indicate very clearly that the articles are in fact neither silver nor ivory nor rabbit. Those opposed follow the pattern of the phrases "Sterling Silver," "African Ivory," and "Jack Rabbit," holding that the modifying term does not at all detract from the character of the essential noun.[48]

Stubbornness is not a virtue; accountants should realize that they live not in a world of their own. Users of financial data, whose servants accountants

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[46] W. A. Paton and W. A. Paton, Jr., op. cit., p. 16.

[47] Morton Backer, (Editor), op. cit., p. 375.

[48] H. R. Hatfield, op. cit., p. 10.

are, are best served by financial statements which can be easily interpreted. To accomplish this, descriptive terminology and the reduction of the variety of items in the shareholders' section of the balance-sheet, should be the goal of all accountants. Descriptive terminology can be developed by using captions which convey the exact meaning of the item. Means by which the variety of items, in the shareholders' section of the balance sheet, can be reduced are given in the concluding chapter.

Evaluation of the Legal Provisions with regard to Surplus, The Corporations Act, Ontario, and The Companies Act, Canada

Legal provisions in accounting usually follow rather than lead accounting theory and practice, that is, theory is crystallized in practice before it is enacted into law. In this respect the Corporations Act, Ontario, is an exception in requiring the total consideration for issued no par shares to be designated as stated or legal capital. A similar provision with regard to par value shares is desirable in view of the above discussion. A provision restricting the use of the term "dividends" to distributions chargeable to current or accumulated prior years' earnings is desirable to draw a clear distinction between distributions of earnings and return of invested capital.

Recommendations for desirable changes in The Companies Act, Canada, should include: (1) requiring the total consideration received for issued shares, par or no par, to be designated as stated or legal capital; (2) deletion of Section 61 (Federal) requiring capitalization of retained earnings to the extent of the par value of preferred shares purchased and redeemed; (3) deletion of part of Section 83 (2) (Federal) permitting companies to charge dividends against "revaluation surplus" five years after the write-up. Revaluation of fixed assets has not been sufficiently refined to warrant any provision in the statutes. (4) With regard to dividends, the provision recommended above for The Ontario Act is desirable.

The disclosure requirements setting out the source and changes in the surplus accounts annually are adequate in both Acts.

CHAPTER IV

CORPORATE DISTRIBUTIONS TO SHAREHOLDERS

Justification for Investing in the Corporation

The fundamental purpose for investing funds in a corporation is the expectation of receiving a stream of future values, the present value of which, discounted at the desired yield rate, is at least equal to the original investment. This view is in agreement with what Professors David H. Li and Harry Sauvain have stated:

> . . . Stock price, in other words, is not a reflection of the "book value" of a stock, but a capitalization of future dividends.[1]

and

> A good case can be made for the proposition that dividends are the only monetary reward for stock ownership (excluding liquidation and control as sources of benefit). A stock may change hands over a period of years, but all that anyone ever gets is dividends.[2]

Earnings are important to the extent that they are usually excellent indicators, perhaps the only indicators of the longevity and the amounts of future corporate distributions to shareholders. If the periodic distributions are less than

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[1]David H. Li, "The Nature of Corporate Residual Equity Under the Entity Concept," The Accounting Review, XXXV (April, 1960), p. 261.

[2]Harry Sauvain, Investment Management (Englewood Cliffs: Prentice-Hall, 2nd ed., 1959), p. 310.

the periodic earnings, then a portion of earnings is reinvested in the corporation with an expectation that future earnings will increase and that future distributions should increase. If the periodic distributions exceed the periodic earnings, a reasonable expectation should be that future distributions will be limited and short-lived. Because of the apparent interdependence of earnings and dividends it is imperative that corporate distributions to shareholders be identified as distributions of earnings or distributions of capital.

Nature of Distributions

Distributions to shareholders can be grouped into two categories: (1) distributions which decrease the corporate assets, and (2) distributions which have no immediate effect on corporate assets. The former requires the disbursement of assets, usually cash, on a pro-rata basis to the shareholders. The latter usually takes the form of subdivision of shareholders' claims ("stock" dividends) or the granting of additional claims to shareholders accomplished through the issuance of securities of a different class than the one already held on a pro-rata basis.

In practice most corporate distributions are referred to as dividends and have been defined as:

> A dividend may be defined as an appropriation of current or accumulated earnings with the intent to distribute an equivalent amount of enterprise assets among the stockholders of a particular class on a pro rata basis. It should be noted that a dividend is "an appropriation . . . with the intent to distribute assets." It is the act of appropriating and not the act of distributing which identifies the dividend.[3]

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[3]Rufus Wixon and W. G. Kell, (Editors), Accountants' Handbook (New York: The Ronald Press Co., 4th ed., 1957), pp. 22-23.

The above definition limits dividend payments to the extent of present and accumulated past earnings. In practice and in the law of most jurisdictions in the United States and Canada,[4] dividends may be paid out of the excess of assets over liabilities, including the stated capital. In addition to what may be referred to as the profit rule and the surplus rule, directors are governed by the capital impairment test and the insolvency test.

The above tests have been designed for two main reasons: (1) protecting creditors against unwarranted distribution of corporate property to shareholders, and (2) protecting shareholders against informal liquidation of their investment in the enterprise. Although the tests seem definitive, problems have arisen in their application to actual situations. In connection with the capital impairment test, the problems which were discussed in Chapter II, "The Corporate Capital," in defining capital apply. Bogen[5] indicates that the courts have used three definitions of the capital that is not to be impaired in connection with the payment of dividends. These are: (1) the par or stated value of the issued shares, (2) the actual dollar consideration received from the share issues, and (3) the capital at the beginning of the accounting period in which dividends are paid.

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[4]Thirty-nine states establish paid-in surplus as a legal source for distributions to preferred shareholders, and 28 of these states extend the availability of paid-in surplus for dividend charges to common shareholders. Harry Buttimer, "Dividends and the Law," The Accounting Review, XXXVI (July, 1961), p. 435. In Canada paid-in or contributed surplus may be utilized for declaration of dividends. The only "surplus" not available for declaration of dividends is the "capital surplus" created under Section 61 of the Federal Act in connection with the purchase and cancellation of preferred shares.

[5]J. I. Bogen, (Editor), The Financial Handbook (New York: The Ronald Press, 3rd ed., 1948).

The first interpretation of capital that is not to be impaired makes available all surplus regardless of source as a measure of dividends. Under this test of impairment of capital, dividends may be declared even though there may be an accumulated deficit on the books of the company as long as "surplus" from other sources exceeds the accumulated deficit. An example would be where a company has contributed surplus and revaluation surplus in the amount of $35,000 and an accumulated deficit of $15,000, in the absence of specific regulations to the contrary, the company may declare and pay a dividend to the extent of $20,000.

The second interpretation regards the total proceeds from stock issues as the capital that is not to be impaired. Under this interpretation, dividends are limited to the extent of earned surplus, plus any revaluation surplus if the latter is not specifically prohibited by provisions of the statutes as available for dividend appropriations.

The third is the most stringent interpretation of the capital that is not to be impaired. Under this interpretation, dividends are limited to the amount of current net income and any revaluation surplus that may be recognized in the current accounting period, providing there is no specific statutory prohibition as to availability of these for dividend appropriations .

The profit test is more restrictive than the capital impairment test and is usually interpreted in two ways. These are: (1) current net earnings, and (2) accumulated net earnings. Under the former, dividends may be declared and paid when current net earnings are present even though the accumulated net earnings may be a negative amount (deficit).[6] Under the latter, dividends may not be declared until such time as the deficit is eliminated. Both views have been supported by prominent authorities. W. W. Cook stated:

> The fact that in a year prior to the declaration of the dividend, some portion of the capital has been lost and has not since been made good affords no ground for restraining the payment of a dividend out of the profits subsequently earned.[7]

F. H. Hurdman does not concur, supporting the accumulated net income interpretation:

> It would appear to be sound economically that, the capital having been diminished by losses, profits should be withheld from distribution as dividends until the loss has been made good, in order that the original status of the stockholder may be restored.[8]

In addition to the capital impairment test and the profit test the statutes may include an insolvency test. This "test" is usually coupled with one or both of the other two "tests" discussed above and prohibits the directors from declaring a dividend if such declaration and subsequent payment would render the company insolvent. Interpretation of insolvency has taken two forms: (1) excess of debts over assets, and (2) inability to meet current debts. Guthmann

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[6]Professor Buttimer reports that ten states permit current earnings' dividends to be declared on both preferred and common shares. Oklahoma provides that the amount of the dividend charge may not exceed one-half of the net income and dividends may be paid on common shares only when no preferred shares are outstanding. Harry Buttimer, op. cit., p. 435.

[7]W. W. Cook, A Treatise on the Law of Corporations (New York: Baker Voorhis Co., 8th ed., 1923), Vol. II, p. 1905.

[8]As cited by H. R. Hatfield, Surplus and Dividends (Cambridge: Harvard University Press 1947), p. 25, from International Congress on Accounting Proceedings, 1929, p. 587.

and Dougall are of the opinion that the insolvency test used alone is not sufficient. They state:

> No dividends may be paid when the company is insolvent or when the payment would result directly in insolvency -- that is, in creating an excess of liabilities over assets. (However, in some states insolvency is used in the equity rather than the bankruptcy sense and means inability to pay debts as they mature.) . . .
>
> The insolvency rule is found in only about one-third of the states, and, taken alone, is less than sound policy would require.[9]

In practice the use of the term "dividend" has been extended to distributions other than those cited in the definition above and use of the term is also applied to capital realignments. Accounting Terminology defines dividend as follows:

> 1. An amount designated for distribution to the shareholders of an incorporated company in proportion to their holdings of shares of the company, having due regard for the respective rights of various classes of shares.
>
> 2. An amount distributed to the shareholders of an incorporated company upon the liquidation of the company.
>
> 3. An amount distributed to the creditors, pro rata, out of the net amount realized in a bankrupt estate.
>
> 4. The amount of 1, 2, or 3 above, received by a shareholder or creditor as the case may be.[10]

The above definition implicitly covers the gradual liquidation of a company engaged in exploiting depletible natural resources. The wasting asset doctrine states:

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[9] H. G. Guthmann and H. E. Dougall, Corporate Financial Policy (New York: Prentice-Hall, Inc., 3rd. Ed., 1955), p. 514.

[10] Accounting Terminology (Toronto: The Canadian Institute of Chartered Accountants, 1957), p. 26.

> . . . a corporation which is engaged in exploiting depletible natural resources need not recognize depletion as a deduction in arriving at the amount of earnings available for dividends, and the amount of dividends need not be broken down between capital and profit in representing the nature of the distribution to stockholders.[11]

Accounting Terminology goes on to define stock dividend as:

> A dividend payable not in cash but by issue of shares of capital stock either of the same or a different class from that in respect of which the dividend is payable.[12]

Corporate distributions are intimately related to the definitions or concepts of corporate capital and corporate surplus. The legal and accounting problems encountered in connection with dividends are therefore, of necessity, those of defining corporate capital and surplus.

Corporate Distributions in Canadian Corporation Law

The legal provisions which govern corporate distributions are as follows:

The Companies Act, Canada

Ancillary Power of Company

Section 92

the declaration and payment of dividends:

Power and Liability of Directors in Dividend Declarations

Section 83 (1)

In this section

(a) "dividend" includes bonus or any distribution to shareholders as such; and

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[11] Rufus Wixon and W. G. Kell, (Editors), op. cit., p. 22-28.

[12] Accounting Terminology, op. cit., p. 70.

(b) "mining company" means a company that for the time being carries on as its principal business the business of operating producing mining properties owned or controlled by it.

(2)

No dividend shall be declared when the company is insolvent[13] or that renders the company insolvent or, subject to subsection (4), that will impair the capital of the company, and in determining the solvency of the company for the purposes of this subsection, no account shall be taken of any increase in the surplus or reserves of the company resulting merely from the writing up of the values of the assets of the company, unless such writing up was made more than five years before the date of the declaration of the dividend.

(3)

For the amount of any dividend that the directors may lawfully declare payable in money they may issue therefor shares of the company as fully paid up, or they may credit the amount of such dividend on the shares of the company already issued but not fully paid up, and the liability of the holders of such shares thereon shall be reduced by the amount of such dividend, if the directors have been authorized to do so by a by-law that has been sanctioned by at least two-thirds of the votes cast at a special general meeting of the shareholders of the company duly called for considering the same, but any such by-law shall not have force or effect for more than one year from the date of its sanction.

(4)

Nothing in this Act prevents a company at least seventy-five per cent in value of the assets of which are of a wasting character, or any mining company from declaring or paying dividends out of its funds derived from the operations of the company notwithstanding that the paid-up capital of the company may be thereby reduced or impaired, if such payment does not reduce the value of its remaining assets so that they will be insufficient to meet all the liabilities of the company then existing exclusive of its paid-up capital.

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[13] Neither Act defines insolvency. J. L. Stewart states that the commonest definition is the inability to pay debts as they become due. J. L. Stewart, Handbook on Canadian Company Law (Toronto: The Carswell Co. Ltd., 5th Ed., 1960), p. 422.

(5)

Where the directors of the company declare and pay any dividend when the company is insolvent, or any dividend the payment of which renders the company insolvent, or that impairs the capital of the company, they are, until repayment of the dividends so declared and paid, jointly and severally liable to the company and to its creditors for the debts of the company then existing or thereafter contracted, but such liability is limited to the amount of such dividends and interest that have not been repaid to the company.

(6)

Where any director present when such dividend is declared forthwith requests the entry on the minutes of the board of his protest against the same, or where any director then absent, within one week after he becomes aware of such declaration and is able so to do, delivers to the president, secretary or other officer of the company his protest against the same, and within eight days thereafter delivers or mails by registered letter a duplicate copy of such protest to the Secretary of State, such director may thereby, and not otherwise, exonerate himself from such liability.

(7)

Nothing in this section shall be deemed to impose upon directors of a company any liability of a character specified in subsection (5), by reason of a declaration or payment of any dividend permitted by subsection (4), or, if such dividend is in excess of the amount so permitted, beyond the amount of such excess.

(8)

The directors may deduct from the dividends payable to any shareholder all such sums of money as are due from him to the company on account of calls or otherwise.

Winding up of Company and Surrender of Charter

Section 29

(1) The charter of a company may be surrendered if the company proves to the satisfaction of the Secretary of State

(a) that it has no assets and that any assets owned by it immediately prior to the application for leave to surrender its charter have been divided rateably amongst its shareholders or members; and either

(b) That it has no debts, liabilities or other obligations; or

(c) that the debts, liabilities or other obligations of the company have been duly provided for or protected, or that the creditors of the company or other persons having interests in such debts, liabilities or other obligations consent; . . .

The Corporations Act, Ontario

Power and Liability of Directors in Dividend Declarations

Section 61

(1) Subject to the special Act, letters patent or supplementary letters patent of the company, the directors may declare and the company may pay dividends on the issued shares of the company.

(2) A dividend may be paid in money or in specie or in kind not exceeding in value the amount of the dividend.

(3) The directors shall not declare and the company shall not pay any dividend or bonus when the company is insolvent, or any dividend or bonus the payment of which renders the company insolvent or that diminishes its capital, and if any dividend or bonus is declared and paid contrary to this subsection, the directors are jointly and severally liable to the company for the amount of the dividend so declared and paid or such part thereof as renders the company insolvent or diminishes its capital.

(4) If any director present when any such dividend or bonus is declared, forthwith, or if any director then absent, within seven days after he becomes aware of such declaration, delivers to any officer of the company his written protest against such declaration, and within seven days after delivery of such protest sends a copy of such protest by registered letter to the Provincial Secretary, such director thereby and not otherwise exonerates himself from liability under subsection 3.

(5) Nothing in this section prevents a mining company or a company whose assets are of a wasting character, or a company incorporated for the object of acquiring and administering the assets or a substantial part of the assets of another corporation, either from such corporation or from the assign of such corporation, for the purpose of converting such assets into money and distributing the money among the shareholders of the company, from declaring and paying dividends out of funds derived from the operations of the company.

(6) The powers conferred by subsection 5 may be exercised notwithstanding that the value of the net assets of the company may be thereby reduced to less than the issued capital of the company if the payment of the dividends does not reduce the value of its remaining assets to an amount insufficient to meet all the liabilities of the company exclusive of its issued capital. 1953, c. 19, s. 61 (1-6).

(7) Subject to subsection 8, the powers conferred by subsection 5 may be exercised only under the authority of a by-law passed by the directors and confirmed by at least two-thirds of the votes cast at a general meeting of the shareholders duly called for considering the by-law.

(8) Where dividends have been paid by a company in any of the cases mentioned in subsection 5 without the authority of a by-law, the payment thereof is nevertheless valid if a by-law adopting and approving the payment is passed by the directors and confirmed by the shareholders in the manner mentioned in subsection 7. 1954, c. 14, s. 11.

Section 62

For the amount of any dividend that the directors may declare payable in money they may declare a stock dividend and issue therefor shares of the company as fully paid or may credit the amount of such dividend on shares of the company already issued but not fully paid, and the liability of the holders of such shares shall be reduced by the amount of such dividend. 1953, c. 19, s. 62.

Winding up of Company and Surrender of Charter

Section 97

(1) Where a company has ceased to carry on business except for the purpose of winding up its affairs and has no debts or obligations that have not been provided for or protected, the directors may pass by-laws for distributing in money, kind, specie or otherwise the property of the company or any part of it rateably among the shareholders according to their rights and interests in the company.

Section 326

(1) The charter of a corporation incorporated by letters patent may be surrendered if the corporation proves to the satisfaction of the Lieutenant-Governor,

> (b) that it has parted with its property by distributing the property rateably among its shareholders or members according to their rights and interests in the corporation;
>
> (c) that it has no debts, obligations or liabilities or its debts, obligations or liabilities have been duly provided for or protected or its creditors or other persons having interests in its debts, obligations or liabilities consent;
>
> (d) that there are no proceedings pending in any court against it; . . .

In addition to the above provisions pertaining to dividends, the Canadian Income Tax Act has the following provision which the company may make use of in order to relieve part of the tax burden of the shareholder.

> A corporation may elect, in prescribed manner and in prescribed form, to be assessed and to pay a tax of 15% on an amount not exceeding
>
> (c) the aggregate of
>
> (i) the dividends declared by it that were paid by it in the taxation years beginning with the 1950 taxation year and ending with the last complete taxation year before the election under this subsection, and
>
> (ii) the dividends that were, by subsection (3) of section 81, deemed to have been received by shareholders of the corporation in consequence of the corporation having paid a stock dividend in the taxation years referred to in sub-paragraph (i).

The right to declare dividends is vested in the directors by both Acts and by the by-laws of the corporation. Both Acts, however, attempt to set limits within which declaration of dividends may take place. The Federal Act as well as the Ontario Act expressly prohibit the payment of dividends which would impair the capital of the company, or which would render the company insolvent. The Acts, however, fail to define what constitutes capital impairment and insolvency. Only in the case of companies with wasting assets do the Acts attempt to define what may be construed as impairment. Dividends may be declared only if the payment will not reduce the value of the remaining assets to a level insufficient to meet all the liabilities of the company exclusive of stated capital. (Federal Section 83(4) and Ontario Section 61(6)). The use of "value of the remaining assets" shrouds the provisions of both Acts in a veil of vagueness. Value is a term with many meanings.

The vagueness of the provisions regarding companies with wasting assets has provoked the following statement:

> In the case of a company engaged in the operation of a property of a wasting nature, e.g., a mine, gas or oil well, there is some doubt whether, apart from any enabling statutory provision, the directors can safely authorize the payment of dividends without setting aside a fund to provide against the exhaustion of the property.[14]

There is no express prohibition in either Act as to the availability of current earnings for dividends before an accumulated deficit has been made good. Although no decisions have been rendered in the Canadian Courts of law, the likelihood is that, if such a case were brought for a decision, the precedent set under English law would be dominant if not prevalent.[15]

Both Acts are silent in the matter of availability of premiums on par shares and amounts in excess of stated value for dividends. There is, of course, no excess of stated value under the Ontario Act as total proceeds constitute

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[14] Ibid., p. 235.

[15] Ammonia Soda Company V. Chamberlain (1918), I Ch. 266, 273, as cited by H. R. Hatfield, op. cit., p. 25. Guthmann and Dougall state, "In England, it is generally accepted that a corporation may use current earnings for dividends without first eliminating any deficit." H G. Guthmann and H. E. Dougall, op. cit., p. 515.

stated capital, however, under the Federal Act up to twenty-five per cent of the proceeds may be designated as "distributable surplus." (Federal 12(10)) In Canada the legal position seems to be that in the absence of express prohibition, premiums and amounts in excess of stated value are available for dividends.[16] No prohibiting provisions are found in either Act.

A divergent opinion is found in the two Acts in the matter of "surplus" resulting from the writing up of the values of the assets of the company. The Federal Act specifically makes "revaluation surplus" available for dividends five years after the revaluation. (Federal Section 83(2)). No provision is found in the Ontario Act with regard to writing up of asset values.

Under the Acts a company may declare a stock dividend and issue to the shareholders on a pro-rata basis the company's authorized but unissued shares as fully paid. If a part or all of the previously issued shares are not fully paid, the stock dividend may be used to reduce the liability to the extent of the retained earnings capitalized. Neither Act, however, states how the amount of the stock dividend is to be determined -- that is, the amount of "surplus" to be capitalized. The stock dividend under the Canadian Income Tax Act is held to be income to the recipient and is, therefore, taxable.

A special unique feature of the Canadian Income Tax Act permits what is usually referred to as a tax-free dividend. Under Section 105(2) of the Tax

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[16] H. A. Finney and H. E. Miller, Principles of Accounting Intermediate, Canadian Edition prepared by K. F. Byrd (Englewood Cliffs: Prentice-Hall, Inc. 1959), pp. 141-42.

Act a company may elect to pay a special 15 per cent tax on an amount of earnings equal to the amount declared as dividends and distribute the balance of earnings as tax free to the shareholders.[17] The maximum advantage is attained when 50 per cent of earnings are declared as dividends and the special 15 per cent tax paid on the balance (50 per cent of earnings). To illustrate, assume that a company with net earnings of $200,000 decides to take the maximum advantage of the special 15 per cent tax. The following entries would be made on the books of the company.

Dividends (Retained Earnings)	$100,000	
Cash (or assets)		$100,000

To record declaration and payment of dividend equal to 50 per cent of net earnings.

Special Tax (Retained Earnings)	15,000	
Cash		15,000

To record payment of the special 15% tax on the amount equal to the amount of the dividend.

Retained Earnings	85,000	
Preferred shares, par,		85,000

To record issuance of preferred shares to shareholders on a pro-rata basis.

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[17] The Act requires that the company first issue redeemable preferred shares to the shareholders on a pro-rata basis, the par of which is equal to the balance of earnings on which the special 15 per cent tax was paid. These shares may then be purchased by the company at par and cancelled. In practice, the issuance and redemption is a mere formality. The only rationale for the procedure is "that this is the way it is done."

Preferred shares	85,000	
Cash		85,000

To record the redemption and cancellation of the preferred shares.

The $85,000 would not be taxable in the hands of the shareholders. The $100,000 dividend would be taxable to the shareholders at the appropriate individual tax rate less a 20 per cent dividend tax credit.[18] This special feature is used primarily in closely held corporations and is designed to give a partial relief of the burden of progressive tax rate on individual income.

Reconsideration of Corporate Distributions

The problems which arise in connection with dividends cannot be disassociated from the concepts of capital and surplus. In fact, most of the problems associated with dividends are predicated on the legal concepts of capital and surplus. Put in another way, the problem is protecting what is not readily or accurately defined to the satisfaction of those concerned. H. W. Ballantine expresses the following opinion:

> No parts of the corporate mechanism are more complicated, unworkable or incomprehensible than the system of legal capital requirements with its various attempted restrictions on unsafe distributions of assets to the shareholders.[19]

Distribution from Contributed "Surplus"

Under the surplus test, or the excess net asset test, contributed surplus, made up of such items as premium on share issues, amounts in excess of

[18] A twenty per cent tax credit is allowed Canadian Income taxpayers on dividends received from Canadian Companies.

[19] H. W. Ballantine, Ballantine on Corporations (Chicago: Callaghan Press, 1946), p. 588.

stated value of issued shares, and donations, is a source or a base for corporate distributions. There are primarily three arguments advanced for considering contributed surplus as a dividend base. These are: (1) gives management more flexibility in the downward adjustment of the size of the corporate unit, (2) early losses can be written off against contributed surplus without the impairment of legal capital, and (3) a dividend base is created in the early stages of the corporation when earnings do not exist.

In essence, the first argument is based on the presumption that at the outset management cannot accurately determine the financial requirements of the corporation. Therefore, part of the proceeds from share issues are designated as contributed surplus and management is given wider latitude in future adjustments of the corporate unit. The adjustment (downward) can be effected without the formality and the required procedure associated with formal capital reductions. The apparent ease with which a downward adjustment of the size of the corporate unit can be effected seems to be in conflict with the legal concern to protect the creditors from unwarranted distributions of corporate assets.

Granted that situations do arise when it is in the interest of all concerned to reduce the scope of corporate endeavour and to return a part of the shareholders' investment to the shareholders. However, if the contraction is accomplished through the formal procedure of reducing legal capital, there is less danger that the rights of the creditors would be abrogated. In a dynamic economy occasions necessitating a reduction of capital are rare and expediency is not a relevant factor. The usual growth pattern of corporations is in stages -- birth, period of growth, period of maturity, and the period of decline. In the growth stage the corporations usually experience increasing earnings accompanied by increasing demands for expansion. Because of the heavy demands for expansion, asset increases resulting from profitable operation are channeled into expansion rather than to the shareholders. Therefore, in the usual situation, contraction in the early stages is an exception rather than the rule. In the later stages, if the company experienced the anticipated earnings, sufficient accumulated earnings should result, with the accompanying flexibility for contraction of the corporation without reducing the legal capital. If, on the other hand, the anticipated earnings did not come to pass, any voluntary contraction should be within the framework of the legal provisions which govern the formal reduction of capital. The latter requirement would give maximum protection to the creditors without impinging on the rights of directors.

The argument that contributed surplus can be utilized to write-off early losses against, thereby not impairing the legal capital, was fully discussed and not found valid in Chapter III, "The Corporate Surplus."

The argument that contributed surplus forms a dividend base in the early stages of the corporation when earnings do not exist fails to reflect the inference of a dividend declaration. In this connection a court expressed the following opinion:

> The declaration of a dividend is the most emphatic assertion that the corporation is in a position to make a division of profits and is consequently enjoying some degree of prosperity.[20]

This view has been endorsed by Ballantine and Hill in the California

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[20]Lockhart v. VanAlstyne, 31 Mich. 76, 80, 18 Am. Rep. 156, as cited by H. W. Ballantine, _Ibid._, p. 572.

Law Review and Littleton in the Accounting Review:

> . . . shareholders ordinarily assume that dividends represent business profits and not a partial return of funds invested.[21]

and

> . . . dividends presuppose profits.[22]

Wixon and Kell concur, stating:

> . . . Limiting dividends to profits is in harmony with the usual stockholder assumption that dividends originate from profits.[23]

Montgomery expands on the subject stating:

> From a common-sense business standpoint, dividends should be paid to stockholders only from accumulated earnings. Dividends have been charged to paid-in surplus or to a surplus other than earned surplus without a clear indication of the source of the dividend and without violating state regulations. That this can be done reflects no great credit to lawmakers, since the incongruity of contributing to the capital of a corporation and then receiving part of it back in the guise of ordinary dividends should be sufficiently evident to encourage making the practice legally impossible. Apart from the legality of such dividends, however, directors may be violating their trust if they declare dividends out of capital without making it clear to the stockholders that the dividends are not distributions of earned surplus.[24]

To this Paton adds:

> . . . there are many cases in which dividend appropriations are based directly, or indirectly, upon funds represented by the contributions of stockholders. It is deplorable that this condition

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[21] As cited by Rufus Wixon and W. G. Kell, (Editors), op. cit., pp. 22-31.

[22] A. C. Littleton, "Dividends Presuppose Profits," The Accounting Review, IX (December, 1934), p. 304.

[23] Rufus Wixon and W. G. Kell, (Editors), op. cit., pp. 22-31.

[24] N. J. Lenhart and P. L. Defliese, Montgomery's Auditing, (New York: The Ronald Press Co., 8th Ed., 1957), p. 407.

is given legal sanction.[25]

and

> The appropriation of regular dividends from capital surplus, whether originally paid in or brought about by a reduction in the acknowledged capital account, is merely a disguised liquidation of the stockholders' investment, and deserves the general condemnation accorded by accountants.[26]

Whether the shareholders' understanding is sufficient to allow a questionable practice is open to question. There is no question that reduction of capital by distribution may take place. However, is it necessary to refer to the distribution as "dividends?" The editor of The Journal of Accountancy considers a dividend "out of" paid-in surplus as a "transformation of capital" into earned surplus, a feat which cannot be accomplished by the resolution of either the stockholders or the directors.[27]

The failure to restrict dividends to distributions of assets in an amount no greater than accumulated earnings is a reflection of the philosophy contained in the Federal and Ontario Acts as to what constitutes legal capital. If these statutes required all shares to be no par shares and that the total proceeds from share issues be designated as legal capital, the problem would be substantially eliminated as premiums on shares and amounts in excess of stated value on issued shares would no longer exist. By the same token, if dividends were limited to the extent of accumulated earnings, premiums on shares and amounts in

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[25] W. A. Paton, Advanced Accounting, (New York: The MacMillan Co. 1941), p. 524.

[26] Ibid., pp. 566-67.

[27] The Editor, "Editorial," The Journal of Accountancy, LXIV (July, 1937), p. 63.

excess of stated value on issued shares would no longer form a dividend base and total proceeds from share issues would form the permanent capital of the company.

Current Net Earnings as a Dividend Base

Whether current earnings, despite an accumulated deficit from past years, should be available for dividends is also predicated on the concept of capital. If the total amount invested by shareholders is to be considered as the legal capital, which is not to be impaired, then the accumulated deficit must be made good before a distribution can take place, regardless of the current profitability of the company. If the capital at the beginning of the accounting period in which profit is realized is not to be impaired, then a distribution may be made out of current earnings.

The courts have taken both views. Justice Petersen stated:

> . . . such a dividend is not paid out of paid-up capital. If it were, the paid-up capital would be still further reduced by the payment. In fact the assets representing the paid-up capital remain the same or of the same value as before the payment of the dividend.[28]

An American court took an opposing view, stating:

> The earned profits, therefore, reduced the impairment, and the declaration of the dividend again impaired the capital to the extent of the dividend declared.[29]

Ballantine made the following statement with regard to the California statutes permitting current earnings' dividends:

> It was the view of the committee that corporations should be able to pay dividends out of current earnings, even though stated capital has become impaired, without the formality of reducing their stated capital. Investors

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[28]Ammonia Soda Company v. Chamberlain, op. cit.

[29]Branch v. Kaiser, et al., 140 Atl. 500 (1928), as cited by H. R. Hatfield, op. cit., p. 25.

> should not be required to forego dividends and income from their investment in order to enable the corporation to make up at once its capital losses if it is making profits from current operations. Prudent management may call for the gradual restoration of capital and a reasonable latitude should be given to the directors as to how rapidly to make up losses of prior years.[30]

The concern of the committee charged with recommending an ideal corporation act in California is with the inconvenience to the shareholders of foregoing a dividend rather than with the protection of the creditors. The question may be raised, if the management is prudent, the commission implies that it is, why have any restrictive legislation with respect to corporate distributions? A second question that arises is that of defining profit. If an enterprise started with $50,000 legal capital and in the first four years experienced total losses of $20,000 and in the fifth year experienced a gain of $2,000, is it correct to state that there has been a net profit in the situation? Hatfield thinks that no net profit exists. He states:

> . . . But to interpret a dividend, paid when there is an operating deficit, as a distribution of profits is an accounting absurdity.[31]

Hatfield continues:

> . . . a continuing policy of so doing, in a business with alternating periods of prosperity and depression, might conceivably result in a gradual elimination of all contributed capital while dividends had been paid, say in

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[30] H. W. Ballantine, "Questions of Policy in Drafting a Modern Corporation Law," California Law Review, XVIII (July, 1931), p. 478.

[31] H. R. Hatfield, op. cit., p. 26.

alternating years, throughout the decadence and destruction of the enterprise.[32]

In the above example the $2,000 gain in the fifth year is only by virtue of the arbitrary length of the accounting period. If the accounting period is extended to five calendar years, then the result would be an $18,000 operating loss and the legal capital would be impaired by the $18,000. There would be no question that under the circumstances a dividend would be illegal.

From the creditors' point of view, allowing companies to pay dividends even though an accumulated deficit is on the books, is undesirable. There is no way of knowing, on the part of the creditors, what they may count upon as an inviolable buffer against losses. Adherence to the theory that legal capital must be maintained would require the accumulation of earnings sufficient to absorb a deficit before there could be any distribution to shareholders from current earnings. To oppose this view is to undermine any significance that may be attached to the concept of legal capital.[33]

If the situation is such that a distribution of assets is desirable and there is no necessity or intention to restore legal capital to the original level, then a formal reduction of capital should be effected and a "fresh

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[32] Ibid., p. 26.

[33] Paton and Paton state: "Where the accumulated deficit is large the rigid application of this rule may seem to work a hardship on investors in need of funds but there is no acceptable alternative without relaxation of the prevailing conception of corporate capital . . . " Wm. A. Paton and Wm. A. Paton, Jr., Corporation Accounts and Statements, (New York: The MacMillan Co. 1955), p. 104.

start" made. The fact that a distribution is made, when an accumulated deficit is on the books, is an indisputable assertion that reduction of capital should be effected.

Revaluation "Surplus" As a Dividend Base

Objection to recognizing revaluation surplus as a dividend base is made not only on the basis that the accounting realization principle is violated, but more important is the fact that such action defies reasonable justification from the going-concern point of view. In a going concern fixed assets derive their value from their ability, as a unit, to generate earnings.[34] If the earning power of the company is so great that a write-up of the fixed assets is warranted or desirable, there should be little necessity to incorporate the amount of the write-up in the dividend base. The large earnings should, in most cases, be more than ample to form the dividend base.

If the write-up of assets is not a result of increased real earning power, but a result of increased price level, incorporation of the write-up in the dividend base is undesirable for two reasons: (1) the reported earnings up to the time of the write-up have been overstated and the dividend base already is inflated, and (2) conservation of corporate funds (in dollar amounts) seems to be desirable if the corporate unit is to remain healthy in the face of the higher cost of assets that will need replacement in the

[34] A. S. Dewing states, "the value of a business is measured by its earning power." and, " . . . There are two measures of value of such a property that may be established by facts: (a) Replacement cost new, less (b) Earning power. The latter will control the former, for if less than a fair return on cost, the value will be less than cost, and if more than a fair return, something more will be added for goodwill, or going value." A. S. Dewing, The Financial Policy of Corporations (New York: The Ronald Press Co., 5th Ed., 1953), pp. 287-88.

future. Paton and Paton state:

> . . . At the same time it should be recognized that a substantial part of the increase in the total of retained earnings in many cases reflects expansion in number of dollars rather than physical growth. As has been emphasized by many writers and analysts there has been a serious overstatement of corporate earnings in the past fifteen years due to the failure of the accounting process to take cognizance of the impact of the decline in the value of the dollar, the accounting yardstick, notably in measuring the depreciation deduction. Another way of putting it is to say that recorded earnings have exceeded disposable income, with the result that it has been necessary to hold a portion of computed earnings in the business to provide the increased number of dollars required to maintain the existing scope of operating activity.[35]

To the above objections may be added that revaluation methods have not been sufficiently refined to be reliable. The allowance of revaluation "surplus" to be incorporated in the dividend base may lead to serious unethical practices which could prove injurious to the creditors, to the shareholders, and to the confidence in the economic community.

Depletion as a Dividend Base

Corporations engaged in extracting natural resources have been permitted by most statutes to: (1) disregard costs applicable to the resources extracted (depletion) in determining the amount of "earnings" which form the dividend base, or (2) if depletion was deducted in arriving at net earnings the amount of the depletion may be added back to net earnings in determining the dividend base. In either case, the resulting dividend base is the same in amount. The philosophy of the statues in

[35] Wm. A. Paton and W. A. Paton, Jr., op. cit., pp. 121-22.

sanctioning the practice is stated as follows:

> . . . The theory of the law is that shareholders and creditors, knowing the nature of the business, should realize that the receipts from sales are in part earnings and in part a return of investment. If the return of investment could not legally be made to the shareholders, the company would be obliged to hold the funds until the exhaustion of the property.[36]

Most accountants have no objection to the gradual liquidation of the company engaged in exploiting depletible natural resources. Accountants are, however, concerned with disclosure of the extent of the liquidation. The prevalent view of accountants is expressed as follows:

> . . . Regardless of what is legally permitted by state laws and under court decisions, the auditor should uphold the principle that paid-in capital should not be impaired by the repayment of stockholders of any of their contributed capital in the guise of ordinary dividends.[37]

There is no question that corporations, whether engaged in fabricating or exploiting of natural resources, should be permitted to adjust the size and scope of their operation by a reduction of legal capital. However, in order that the shareholders and creditors are not misled, reduction of legal capital should be formal, as provided for by the statutes.[38]

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[36] H. A. Finney and H. E. Miller, Canadian Edition, _op. cit._, pp. 375-76.

[37] N. J. Lenhart and P. L. Defliese, _op. cit._, p. 409. Similar views are expressed by A. W. Holmes, G. P. Maynard, J. E. Edwards, and R. A. Meier, _Intermediate Accounting_ (Homewood: Richard D. Irwin, Inc., 3rd. Ed., 1958), p. 380; L. L. Vance, _Accounting Principles and Control_ (New York: Holt, Rinehard and Winston, Inc. 1960), p. 454; A. W. Johnson, _Intermediate Accounting_ (New York: Rinehard & Co. Inc., Revised Ed., 1958), p. 285; to name only a few.

[38] The legal philosophy is presumptuous as to the ability of shareholders and creditors to distinguish the portion of the distribution that is a return of invested capital and the portion that is a distribution of earnings.

From the creditors' and shareholders' points of view, a desirable objective would dictate that the accounting policy and financial administration policy be clearly distinguished.

Capitalization of "Surplus"

The capitalization process is the transferring of a desired amount from the "surplus" category to the legal capital category. The transfer may be accomplished in two main ways: (1) increasing the par or stated value of outstanding shares; (2) by issuing additional shares pro rata to the shareholders as fully paid, or, (3) cancelling the real or contingent liability of the shareholders resulting from discounts on issued shares (where permitted by law and which are assessable) and unpaid subscriptions.

The second method is of special interest because of the accounting problems that arise when used and because of the term "dividend" that is attached to the shares being issued. There are primarily three main problems connected with stock "dividends." These are: (1) the determination of the amount to be transferred, (2) type of "surplus" to be converted, and (3) taxability of the "dividend" in the hands of the recipient.

There is no uniformity or concensus of opinion among accountants as to the per share amount to be transferred from "surplus" to legal capital on issuance of stock "dividends." The American Institute recommends that fair value of the additional shares be transferred. The committee states:

> . . . 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.[39]

Lenhart and Defliese concur, stating:

> In the authors' opinion, the date of declaration of a stock dividend is the most logical point at which to determine fair value of the shares issued.[40]

On the other hand, Paton and Paton state:

> The preferable accounting procedure, accordingly, is to determine the number of shares needed to capitalize a given amount of retained earnings by using as a divisor the <u>capital</u> book value per share (either par or stated value or, more logically, average amount received per share from stockholders) . . .[41]

Wixon and Kell support the average amount paid in per share. They state:

> . . . a preferred base amount agreeable to all parties, including the New York Stock Exchange and the Securities and Exchange Commission, would seem to be the average amount paid in per share on the shares issued (this ignores treasury shares) at the stock dividend date. This figure has the merit of permitting both owners and creditors to think in terms of the same per-share investment or protection as they did before the stock dividend.[42]

The difficulty of justifying the fair value method is found in the

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[39]Committee on Accounting Procedure, <u>Restatement and Revision of Accounting Research Bulletins, Bulletin</u> No. 43, (New York: American Institute of Certified Accountants, 1953), pp. 51-2.

[40]N. J. Lenhart and P. L. Defliese, <u>op. cit.</u>, p. 406.

[41]W. A. Paton and W. A. Paton, Jr., <u>op. cit.</u>, p. 125.

[42]Rufus Wixon and W. G. Kell, (Editors), <u>op. cit.</u>, p. 21.44.

dissenting opinion of Messrs. Calkins and Mason, members of the Committee on Accounting Procedure of the American Institute. They point out that in essence the justification contained in Bulletin No. 43 of capitalizing of fair value is based on the assumption that the shareholder thinks the stock dividend is income.[43]

The average amount paid in per share, as suggested by Paton and Paton and the editors of The Accountants' Handbook, is equally difficult to justify in jurisdictions which permit contributed "surplus" distributions. The weakness in capitalizing the average amount paid in per share is that a portion of the retained earnings will not be transferred to the permanent capital account if the average is greater than the par or stated value of the shares. The excess of the average price received per share over the par or stated value will be transferred to the contributed "surplus" account and will be no more "permanent" than retained earnings or other "surplus" accounts.

The above arguments lead to the conclusion that in jurisdictions permitting other than earned "surplus" dividends the amount of transfer per share should be the par or stated value since only the par amount is permanently "frozen." In jurisdictions which permit only earned "surplus" dividends the amount capitalized per share should be left to the discretion of management. No doubt management may have certain policies which are followed in capitalizing retained earnings and should be left free to attain these policies.

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[43]Committee on Accounting Procedure, op. cit., p. 54.

The type of "surplus" to be capitalized is also related to the legal provisions of the statues. If all "surplus" forms the dividend base then a transfer from any type of "surplus" decreases the dividend base and increases legal capital. Opinions have been expressed for first capitalizing "surplus" other than earned. Professor Horngren states:

> The principal reason for advocating such treatment is that such a charge will lessen the confusing breach between contributed capital and legal capital.[44]

Professor Horngren's statement is in agreement with that of R. P. Marple, who stated:

> Since capital surplus represents an excess of contributed capital over legal capital, the declaration of stock dividends out of capital surplus has the effect of converting contributed capital into legal capital and of reducing the excess. Accordingly, there can seem to be no logical objection to dividends from this source.[45]

In jurisdictions where only the earned "surplus" forms the dividend base, to accomplish an increase in the legal capital a portion of the earned surplus must be transferred as other "surplus" already is part of the legal capital. If the desired result of a stock dividend is to decrease the dividend base and increase the legal capital, the type of "surplus" to be capitalized is predicated on the definition or concept of legal capital.

Taxability of stock dividends in the hands of the recipient is dependent on whether value has been received. The dominant view, in situations

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[44]C. T. Horngren, "Stock Dividends and the Entity Theory," The Accounting Review, XXXII (July, 1957), p. 381.

[45]R. P. Marple, Capital Surplus and Corporate Net Worth (New York: The Ronald Press Co., 1936), p. 165.

where common shares are distributed to common shareholders, is that nothing of value is received by the shareholders. The "dividend" is a pure paper transaction. The American Institute states:

> . . . In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.[46]

In a court decision Justice Pitney approved the following view:

> A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased . . . the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.[47]

Sometimes the argument is advanced that the shareholder may declare his own cash dividend by selling the shares he receives as a stock dividend. However, since a stock dividond is pro rata, the sale of the new shares is exactly the same as selling some of the original shares, that is the shareholder's equity in the company is reduced.

Another argument advanced for viewing a stock dividend as income in the hands of the recipient is that the procedure is a condensation of two transactions:

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[46]Committee on Accounting Procedure, op. cit., p. 50.

[47]Eisner v. Macomber, 252 U. S. 189, ibid., pp. 50-51. Similar views are held by W. A. Paton and W. A. Paton, Jr., op. cit., p. 129-130; A. C. Whitaker, "The Stock Dividend Question," The American Economic Review, XIX (March, 1929), pp. 20-42; Shaw Livermore, "Value of Stock Dividends," The American Economic Review, XX (December, 1930), pp. 687-691, to cite only a few.

(1) a pro rata distribution in cash, and

(2) a pro rata reinvestment of cash by the recipient shareholders.[48]

This argument is weak in that it is based on "as if" condition. The shareholder does not perform the act of investing, as the capitalization of "surplus" via a stock dividend is a corporate decision, not the stockholder's. Moreover, if the above view were approved, what would stop a corporation from unilaterally "completing" a sale of goods and "repurchasing" the same goods, all on paper, for a higher price. Both transactions are the same in principle and sanctioning the former is equivalent to sanctioning the latter.

The strongest argument for recognizing a stock dividend as income in the hands of the recipient is based on the distinction placed on invested capital and earned "surplus." If the invested capital is interpreted as the equity of the shareholders and earned "surplus" as the equity of the corporation, then a capitalization of earned "surplus" is a transfer from the corporate equity to the shareholders' equity. Since the shareholders' equity is increased by the capitalized amount, shareholders, it is interpreted, received something they did not have before. Professor G. R. Husband expressed the following view on the treatment of stock dividends as income:

> . . . If from the entity viewpoint, the income of the corporation is not to be interpreted as the income of the stockholder, and if the resulting earned surplus is not the equity of the stockholder, the stock dividend would appear to transfer an amount from the corporate entity's equity to the equity of the stockholders and thus to meet the test of inoome. It should be evident, therefore, that

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[48]Rufus Wixon and W. G. Kell, (Editors) op. cit., p. 21.42.

> the accountant cannot consistently hold the entity viewpoint and deny that the stock dividend constitutes income.[49]

Paton and Paton disagree on the receipt of income. They state:

> . . . Adoption of this view (entity concept) means that the earnings of the corporation are not income to the investor and can become income to him only through the process of transferring corporate assets to him. Increasing the number of shares held does not meet this requirement, regardless of how the transaction is described . . . It simmers down to this: (1) if the corporation is regarded as a separate entity the shareholder receives income only as corporate assets are transferred to him; (2) if the corporation is regarded as a steward or agent income accrues to the shareholder as earned through the agent's efforts; (3) under neither view does it make sense to regard the act of cutting the pie into a greater number of pieces as producing income to anyone.[50]

From the income determination point of view, the realization principle should be the deciding factor. Does the shareholder have, after receipt of a stock "dividend," something at his disposal which he did not have before? The answer must be 'no.' Therefore, no income was received by the shareholder. Income is received by the shareholder only when: (1) he, the shareholder, receives a dividend in cash or other assets without impairment of his investment; (2) when he, the shareholder, receives on partial or complete liquidation, assets whose value is in excess of the original investment. In the second situation, only the excess amount would be considered as income.

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[49] G. R. Husband, "The Corporate-Entity Fiction and Accounting Theory," The Accounting Review, XIII (September, 1938), p. 246.

[50] W. A. Paton and W. A. Paton, Jr., op. cit., pp. 129-30.

Acceptance of the realization principle as the governing factor is acceptance of the view that the shareholders do not derive any income from a pro rata common share distribution to common shareholders. This type of stock "dividend," therefore, should not be subject to income tax.

Summary

The leading problems in connection with the distribution of corporate assets are: (1) the use of the term "dividends" to describe most of such distributions, and (2) the definition of the measure of distribution.

Declaration of a dividend is the most emphatic assertion that the corporation is in a position to make a division of earnings. To shareholders the term "dividend" is synomous with the division of earnings and not a partial return of invested funds. To accountants the incorporation of "surplus" other than "earned surplus" in the dividend base is a distinct departure from basic accounting thought as to the nature of invested capital and dividend distribution. Distributions not charged against "earned surplus" are pro rata payments in liquidation so far as accounting is concerned and should be so regarded.

Identification of corporate distributions should be as follows: (1) the interests of those concerned would best be served if the term "dividend" was restricted and used only in connection with division of earnings, and (2) distributions other than division of earnings are liquidations and should be so identified.

In connection with the definition of the measure of distribution, A. C. Littleton is of the opinion that the profit concept has not been exclusively used in corporation law as the only test for dividends because of the unwillingness to define the broad term "profit." A solution lies in the following recommendation:

> Cash dividends may be declared only out of current or accumulated net income which has been ascertained according to the accepted principles.[51]

The above recommendation incorporates both the profit test and solvency test for dividend declarations. Stating the law of dividends in the recommended form would allow directors and the courts to base their decisions upon the broad foundations of expert opinion and an extensive technical literature rather than upon an interpretation of a single definition or a single rule. Accountants fully endorse the accumulated profits test and the meaning of "dividend" to accountants is consistent with their desire to maintain a primary distinction between invested and earned capital.

In the interpretation of "dividends" in shares of the company, the realization principle should dominate. Nothing is realized when a pro rata distribution of the company's own shares is made, therefore no "dividend" as such exists.

Evaluation of the Legal Provisions with Regard to Corporate Distributions, The Companies Act, Canada, and The Corporations Act, Ontario

In an effort to protect the creditors and perhaps the shareholders, both Acts have tended to use terminology which shrouds the legal intent in obscurity.

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[51] A. C. Littleton, "Business Profits as a Legal Basis for Dividends" Harvard Business Review, XVI (October, 1932), p. 60.

What is the meaning of value as used in Section 61(6), Ontario Act? What is the meaning of insolvency? What is the meaning of impairment of capital when capital is not accurately defined? Can a dividend be declared when a deficit is on the books, but the company is currently showing net earnings? How is the amount of "surplus" to be capitalized determined when shares are issued with this intent? Is a "dividend" a division of earnings or a gradual liquidation of the company?

Recommendations for changes in the Acts are:

(1) Restrict the use of the term "dividend" to describe corporate distributions chargeable to current and/or accumulated earnings to draw a clear distinction between distribution of earnings and return of invested capital; (2) provide that distributions chargeable to "surplus" accounts other than earned surplus can be effected only under sections governing capital reductions; (3) provide that distributions in excess of accumulated earnings in companies exploiting depletible assets can be effected only under sections which govern capital reductions; (4) use meaningful terminology which in itself does not raise questions as to the intended meaning; and (5) prohibit the incorporation of revaluation "surplus" in the dividend base Section 83(2) Federal Act.

Some of the above recommendations necessarily overlap with the recommendation in Chapters II and III on the "Capital of the Corporation" and "The Corporate Surplus." The problems are intimately related and a solution in one area is, in many cases, a solution in other areas.

CHAPTER V

CORPORATE COMBINATIONS

Corporate combination is the bringing together of two or more previously independent enterprises into a single economic unit.[1] The study of the reasons for corporate combinations is primarily the province of economists.[2] To accountants is left the task of interpretation of the characteristics of combinations in order that the accounts may reflect the nature or substance of the "marriage." As a consequence accountants have come to distinguish between combinations which are regarded as purchases of assets and those which represent a pooling of interests. The essential characteristics which differentiate the two designations are as follows:

> For accounting purposes, a purchase may be described as a business combination of two or more corporations in which an important part of the ownership interests in the acquired corporation or corporations is eliminated or in which other factors requisite to a pooling of interests are not present.
>
> In contrast, a pooling of interests may be described for accounting purposes as a business combination of two or more corporations in which the holders of substantially all of the ownership interests (refers basically to common stock) in the constituent corporations become the owners

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[1]Adapted from R.L. Nelson, Merger Movements in American Industry 1895-1956, (Princeton University Press, 1959), p. 3, and E.B. Wilcox, "Business Combinations: An Analysis of Mergers, Purchases, and Related Accounting Procedure," The Journal of Accountancy, LXXXIX (February, 1950), p. 102.

[2]The following comment indicates the inadequacy of knowledge on corporate combinations: "The role of mergers in the evolution of our economic structure and especially of the large and often dominant industrial enterprises, has fascinated American economists and legislators since the 1890's. Unfortunately, both economic analysis and legislative policy have been handicapped by inadequate knowledge." R.L. Nelson, op. cit., p. 3.

of a single corporation which owns the assets and businesses of the constituent corporations. ..... such corporation may be one of the constituent corporations or it may be a new corporation.

When a combination is deemed to be a purchase, the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such consideration, or at the fair value of the property acquired, whichever is more clearly evident.....

When a combination is deemed to be a pooling of interests, a new basis of accountability does not arise. The carrying amounts of the assets of the constituent corporations, if stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform accounting basis, should be carried over; and the combined earned surplus and deficits, if any, of the constituent corporation should be carried forward, except to the extent otherwise required by law or appropriate corporate action ..... the pooling-of-interests concept implies a combining of surpluses and deficits of the constituent corporations, and it would be inappropriate and misleading in connection with a pooling of interests to eliminate the deficit of one constituent against its capital surplus and the carry forward the earned surplus of another constituent.[3]

The characteristics of a purchase are: (1) the elimination of an important part of ownership in the acquired corporation; and (2) the assets acquired are recorded on the books of the acquiring company at cost.[4]

The significant characteristics of the pooling of interests are: (1) carrying forward to the new corporation the combined earned "surpluses" or deficits of the predecessor corporations; and (2) apparent disregard for the effect of the charging price level on the fixed assets of the

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[3]Committee on Accounting Procedure, Accounting Research Bulletin No. 48, American Institute of Accountants, 1957, pp. 21-25. The term "Pooling of Interests" was suggested by E. B. Wilcox in 1950. See E. B. Wilcox, op. cit., pp. 102-05.

[4]Consistent with the applicable accounting principle for the purchase of assets, expenditures incidental to the purchase are part of the cost of acquired assets.

combining corporations.[5] George O. May is of the opinion that Bulletin No. 48 is in conflict with the declaration set out in the first accounting bulletin which stated:

> The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet changes as they occur.[6]

The weakness of the pronouncements of Bulletin No. 48 in the opinion of G.O. May, lies in the disregard of current values. He states:

> . . . these monetary ascriptions will be the more significant and useful the more closely they reflect the effective cost to present-day stockholders of their interest in the surviving corporation, rather than the effective cost to stockholders of a prior generation. There is always a presumption in favor of a more recent measure of accountability as against an earlier one and the presumption becomes stronger the older the historical base is.
>
> Prima facie the securities issued in a transaction must be assumed to be issued at the same price to all recipients; the burden of proof lies on those who seek to depart from this rule.[7]

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[5]J. A. Carson sets out the following characteristics of mergers based on The American Institute Bulletin No. 48: "(1) the smaller of the two companies in a transaction is substantial in relation to the assets and earnings of the combined companies, (2) the ultimate ownership of the stock of the combined companies held by the former owners of the smaller company is substantial in relation to the overall ownership, (3) there is some continuity both of such ownership and of management of the business acquired." J. A. Carson, "Accounting for Mergers and Consolidations," The Canadian Chartered Accountant, LXXIV (April, 1959), p. 326. The above are tests of pooling of interests rather than characteristics of mergers.

[6]Committee on Accounting Procedure, Restatement and Revision of Accounting Research Bulletins, Bulletin No. 43, (New York: American Institute of Certified Public Accountants, 1953), p. 7.

[7]George O. May, "Business Combinations: An Alternate View," The Journal of Accountancy, CIII (April, 1957), p. 35.

With reference to the carry-over of earned "surpluses" and deficits of the combining corporations, G.O. May is of the opinion that E.B. Wilcox provides sufficient ground for rejection of the practice.[8] Wilcox states:

> Obviously an operating deficit on the books of one predecessor could greatly reduce or eliminate the remaining earned surplus, and there might even be a net deficit in the surviving company.[9]

The rejection is based on the fact that the emerging corporation may begin operations with a deficit. The lack of unanimity among accountants with regard to the carry-over of earned "surplus" or deficit is indicated by the following expressions:

> . . . Specific earned surplus measures the profit accumulation of a specific corporation, not the accumulation of fused or successive concerns. A complete merger is equivalent to the formation of a new enterprise, and a new company cannot begin its corporate life with an earned surplus.[10]

and

> The combined earned surpluses and deficits, if any, of the constituent corporations should be carried forward ..... the new enterprise is nevertheless regarded as a continuation of all the constituent corporations; the rule applicable to purchased subsidiaries that earned surplus created prior to acquisition does not form part of consolidated earned surplus does not apply.[11]

The Canadian Institute has not taken a stand on the matter; however, by implication, the carry-over of surpluses and deficits is accepted.

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[8] Ibid., p. 33.

[9] E.B. Wilcox, op. cit., p. 105.

[10] W.A. Paton and A.C. Littleton, An Introduction to Corporate Accounting Standards, American Accounting Association, 1940, p. 107.

[11] N.J. Lenhart and P.L. Defliese, Montgomery's Auditing, (New York: The Ronald Press Co., 8th Ed., 1957), p. 473.

The Institute states:

> The consolidated earned surplus should in no case include surpluses of subsidiaries earned prior to acquisition. Likewise, in respect of subsidiaries acquired during the year, the profit and loss statement should include only the operations since the effective date of acquisition. (It should be noted that a "pooling of interests" is not an acquisition.)[12]

In view of the fact that the phrase "pooling of interests" is used to imply that a differentiation in accounting treatment of corporate combinations is warranted, a formal pronouncement by the Canadian Institute would be desirable.

The Canadian corporate statutes do not deal specifically with the problem of carry-over of earned "surpluses" and/or deficits. However, the statutes of all jurisdictions are not in agreement on the subject of corporate combinations. The chief difference is that in all jurisdictions except Manitoba and Quebec the emerging company is regarded as a continuation of the predecessor companies, while in Manitoba and Quebec the emerging company is regarded as a new incorporation.[13]

There is disagreement in jurisprudence as in accounting, concerning corporate combinations. The source of the differences is the same in both accounting and jurisprudence. The solution of the differences seems to be predicated on the solution to the question: Can there be a corporate combination and at the same time a continuation of accounting for the combination as if the predecessor companies had not lost their identity?

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[12] Committee on Accounting and Auditing Research, Accounting and Auditing Practices Bulletin No. 14, (Toronto: The Canadian Institute of Chartered Accountants, 1957), p. 9.

[13] The Quebec Companies' Act, (1925), Section 18 and Manitoba Companies' Act, (1954), Sections 98, 99 and 100. Also J. L. Stewart, Handbook on Canadian Company Law, (Toronto: The Carswell Co. Ltd., 5th Ed., 1960), p. 319.

Federal and Ontario Corporate Statutes on Combinations

The Companies Act, Canada

Power to Amalgamate

Section 14

(h) to promote any other company or companies for the purpose of acquiring or taking over all or any of the property and liabilities of the company, or for any other purpose that may seem directly or indirectly calculated to benefit the company;

(m) to sell or dispose of the undertaking of the company or any part thereof for such consideration as the company may think fit, and in particular for shares, debentures or securities of any other company that has objects altogether or in part similar to those of the company;

(u) to distribute among the shareholders of the company in kind, specie or otherwise, any property or assets of the company including any proceeds of the sale or disposal of any property of the company and in particular any shares, debentures, or other securities of or in any other company belonging to the company, or of which it may have power to dispose, if either such distribution is made for the purpose of enabling the company to surrender its charter under the provisions of this Act, or such distribution, apart from the provisions of this paragraph, would have been lawful if made in cash;

Section 126

(4) The expression "arrangement" as used in this section and section 127 shall be construed as extending to any reorganization of the share capital of the company including without limiting the foregoing the consolidation of shares of different classes, the division of shares into shares of different classes, the conversion of shares into shares of another class or classes and the modification of the provisions attaching to shares of any class or classes and as including the amalgamation or reconstruction as hereinafter defined; the expression "amalgamation or reconstruction" means an arrangement pursuant to which a company (in this subsection called "the transferor company") transfers or sellls or proposes to transfer or sell to any other company (in this subsection called "the transferee company"), the whole or a substantial part of the business and assets of the transferor company for a consideration consisting in whole or in part of shares, debentures or other securities of the transferee company and, either,

any part of such consideration is proposed to be distributed among shareholders of the transferor company of any class, or, the transferor company proposes to cease carrying on the business or part of its business so sold or transferred or proposed to be sold and transferred. 1934, c. 33, s. 122.

Designation of "Surplus"

Section 12

(10) . . . and where the company acquires a going concern that has a surplus over and above all liabilities, and any shares without nominal or par value in the company are issued and allotted as fully paid in payment or part payment for such going concern, the directors may by resolution set aside, as a distributable surplus, such part of the consideration for the issue and allotment of such shares without nominal or par value as does not exceed the unappropriated balance of realized net profits of the going concern immediately before such acquisition.

Rights of Dissenting Shareholders

Section 128

(1) Where any contract involving the transfer of shares or any class of shares in a company (in this section referred to as "the transferor company") to any other company (in this section referred to as "the transferee company") has, within four months after the making of the offer in that behalf by the transferee company, been approved by the holders of not less than nine-tenths of the shares affected, or not less than nine-tenths of each class of shares affected, if more than one class of shares is affected, the transferee company may, at any time within two months after the expiration of the said four months, give notice, in such manner as may be prescribed by the court in the province in which the head office of the transferor company is situate, to any dissenting shareholder that it desires to acquire his shares, and where such notice is given the transferee company is, unless on an application made by the dissenting shareholder within one month from the date on which the notice was given the court thinks fit to order otherwise, entitled and bound to acquire those shares on the terms on which, under the contract, the shares of the approving shareholders are to be transferred to the transferee company.

The Corporations Act, Ontario

Power to Amalgamate

Section 22

(h) to promote any company for the purpose of acquiring or taking over any of the property and liabilities of the company, or for any other purpose that may benefit the company;

(m) to sell, lease, exchange or dispose of the undertaking of the company or any part thereof as an entirety or substantially as an entirety for such consideration as the company thinks fit, and in particular for shares or securities of any other company having objects altogether or in part similar to those of the company, if authorized so to do by a special resolution.

Section 95

(1) In this section, "arrangement" includes a reorganization of the authorized capital of a company and includes, without limiting the generality of the foregoing, the consolidation of shares of different classes, the reclassification of shares of a class into shares of another class and the variation of the terms, preferences, rights, conditions, restrictions, limitations or prohibitions attaching to shares of any class and includes a reconstruction under which a company transfers or sells or proposes to transfer or to sell to another company the whole or a substantial part of its undertaking for a consideration consisting in whole or in part of shares or securities of the other company and in which it proposes to distribute a part of such consideration among its shareholders of any class or to cease carrying on its undertaking or the part of its undertaking so transferred or sold or so proposed to be transferred or sold. 1953, c. 19, s. 95 (1); 1955, c. 9, s. 7.

Section 96

(1) Any two or more companies, including a holding and subsidiary company, having the same or similar objects may amalgamate and continue as one company.

(2) The companies proposing to amalgamate may enter into an agreement for the amalgamation prescribing the terms and conditions of the amalgamation, the mode of carrying the amalgamation into effect and stating the name of the amalgamated company, the names, callings and places of residence of the first directors thereof and how and when the subsequent directors are to be elected with such other details as may be necessary to perfect the amalgamation and to provide for the subsequent management and working of the amalgamated company, the authorized capital of the amalgamated company and the manner of converting the authorized capital of each of the companies into that of the amalgamated company.

(3) The agreement shall be submitted to the shareholders of each of the amalgamating companies at general meetings thereof called for the purpose of considering the agreement and if two-thirds of the votes cast at each such meeting are in favour of the adoption of the agreement that fact shall be certified upon the agreement by the secretary of each of the amalgamating companies under the corporate seal thereof.

(4) If the agreement is adopted in accordance with subsection 3, the amalgamating companies may apply jointly to the Lieutenant-Governor for letters patent confirming the agreement and amalgamating the companies so applying and on and from the date of the letters patent such companies are amalgamated and are continued as one company by the name in the letters patent provided, and the amalgamated company possesses all the property, rights, privileges and franchises and is subject to all liabilities, contracts, disabilities and debts of each of the amalgamating companies. 1953, c. 19, s. 96.

Rights of Dissenting Shareholders (Private Company) [14]

Section 99

(1) (c) an agreement for the amalgamation of the company with one or more other companies, whether public or private, is confirmed by the shareholders, any shareholder who has voted against the confirmation of such resolution or agreement, as the case may be, may within two days after the date of the meeting give give notice in writing to the company requiring it to purchase his shares.

(2) Within ninety days from the date of the completion of the sale or disposition or the issue of the supplementary letters patent or the letters patent, as the case may be, the company shall purchase the shares of every shareholder who has given notice under subsection 1.

(3) The company shall not purchase any shares under subsection 2 if it is insolvent or if such purchase will render the company insolvent.

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[14]In Canada, a company classified as a private company, by virtue of the Act under which incorporation took place, enjoys special privileges. These privileges are primarily in disclosure of data about the company. In order to be incorporated as a private company certain restrictions are imposed by the Act. Restrictions of importance are: (1) the number of shareholders is limited to fifty; (2) restrictions are placed on the transfer of shares; and (3) funds may not be raised through public offerings. A public company in Canada is synonymous with a private company in the United States; a crown company in Canada is synonymous with a public company in the United States.

(4) The price and terms of the purchase of such shares shall be as may be agreed upon by the company and the dissenting shareholder, but, if they fail to agree, such price and terms shall be as determined by the court on the application of the dissenting shareholder.

Preservation of Creditor's Rights

Section 323

All rights of creditors against the property, rights and assets of a corporation amalgamated under section 96 or continued under section 322, and all liens upon its property, rights and assets are unimpaired by such amalgamation or continuation, and all debts, contracts, liabilities and duties of the corporation thenceforth attach to the amalgamated of continued corporation and may be enforced against it. 1953, c. 19, s. 323; 1955, c. 9, s. 17.

Both the Federal and the Ontario Acts provide for the right of corporations to amalgamate.[15]

The Ontario Act in Section 96 details the procedure to be followed in the amalgamation. In Section 96(2) of the Ontario Act "the manner of converting the authorized capital of each of the companies into that of the amalgamated company" is to be stated in the agreement for the amalgamation. The Act apparently distinguishes the entities involved: "each of the companies" and "the amalgamated company." The Act, however, is silent on the matter of carry-over of earned "surplus" from the amalgamating companies to the emerging company.

With regard to dissenting shareholders the Ontario Act provides for relief only in the case of private corporations.[16] The Ontario Act seeks to protect the creditors' rights against the amalgamated or continuing corporation.

The procedure for amalgamation is not specifically detailed in the Federal Act. Reference is, however, made to dissenting shareholders. Under the Federal Act (Section 128 (1)) the acquiring company may force the dissenting shareholders to comply with the terms of offer if the dissenting shareholders hold less than ten

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[15]The term "amalgamate" rather than "combine" is used by both Acts. The terms as used here are synonymous.

[16]See footnote No. 14, p. 9.

per cent of the outstanding shares of the company being acquired.

With reference to the carry-over of earned "surplus" the Federal Act under Section 12 (10) permits the designation of an amount not exceeding "the unappropriated balance of realized net profits" of the going concern being acquired as "distributable surplus." This is permitted only when no par shares are issued as part of full consideration of the acquiring company. Since "distributable surplus" is unrestricted and included in the dividend base of the emerging company, the Act, in fact, permits the carry-over of earned "surplus" from the going concern being acquired to the acquiring company.

The two Acts have little in common on the matter of corporate amalgamations or combinations. Of prime accounting importance is the fact that the Ontario Act apparently attempts to distinguish the entity of the amalgamating corporations and the emerging corporation, however, no statement is made with regard to the carry-over of the predecessor companies' earned "surplus" providing no par shares are issued as the emerging company's consideration and the carried over "surplus" is designated as "distributable surplus." Both Acts are silent on whether the assets are to be recorded at book or market values on the books of the emerging company.

Reconsideration of Corporate Combinations

The underlying accounting problem of corporate combinations is centered around the carry-over of earned "surplus" of the predecessor companies to the emerging corporation. The problem of the carry-over of earned "surplus" is essentially predicted on whether the entities of the combining companies are preserved.

Acquisition of Existing Corporations[17]

The generally accepted accounting standard for the acquisition of assets is as follows:

> . . . The importance of cost as a record of the accountability of an enterprise for its resources makes it essential that their determination be based on available objective evidence. When an asset is purchased such evidence is found in the cash outlay, in the fair market value of any noncash consideration, or, in the absence of these measures of cost, in the fair market value of the asset acquired. Where an asset is acquired from investors or donors its cost for accounting purposes is fair market value at the time of acquisition.
>
> (1) The cost of a group of assets acquired for a lump sum should be allocated to property units, tangible or intangible, after careful consideration of each unit, and its intended use and prospective earning power or value in exchange.[18]

The above pronouncement of the American Accounting Association provides for both the piecemeal acquisition of assets and group acquisition such as acquiring a going concern. The assets in both cases are recorded on the books of the acquiring company at acquisition cost. Consideration for the acquired assets may be either other assets and/or participation in the ownership of the acquiring corporation.

The fact that the shares of the acquiring corporation are issued to the previous owners is of no consequence as to the amount at which the assets are to be recorded on the books of the acquiring corporation. Of consequence is the fact that: (1) the ownership of the assets passed to the acquiring corporation; and, (2) a consideration equal in value to the assets was given to the previous owners in return. The value and not the type or magnitude of the consideration is all

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[17]The term "acquisition" rather than "purchase" is used in order that the consideration given in return for the acquired assets may be other assets and/or shares of the acquiring corporation.

[18]American Accounting Association, Accounting Concepts and Standards Underlying Corporate Financial Statements and Supplements, 1948 Revisions, p. 2.

important. Although the previous owners remain owners, they are not owners of the specific assets passed to the acquiring corporation, but owners of the cross section of all assets of the acquiring corporation.

The above interpretation of the American Accounting Association's pronouncement is somewhat in conflict with the definition of a "purchase" by the American Institute's Bulletin No. 48. In Bulletin No. 48 a purchase requires: (1) that an important part of the ownership interests in the acquired corporation or corporations be eliminated; and (2) that the corporation acquired not be of substantial size in terms of assets and earnings to the combined companies. What constitutes "an important part" or "substantial size" is not clearly defined in the bulletin.

Acquisition of assets by one corporation from another corporation, or corporations, should be identified by the passage of title (asset ownership) to a corporation from another or other corporations. Where total ownership does not pass, majority interest and control of assets should be the test of an acquisition of assets. Magnitude (value), form of consideration given in return or continuity of ownership are irrelevant.

The Carry-Over of Surplus

The arguments presented for permitting the carry-over of surplus from the predecessor companies to the emerging company are primarily based on: (1) the premise that the entities of the combining corporations are preserved; and (2) since the assets and liability account balances can be transferred to the new surviving company at existing carrying values, the transfer of earned "surplus" should be equally acceptable.[19] If the premise that the entity

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[19]The second argument is adapted from: H. A. Finney and H. E. Miller, Principles of Accounting Intermediate, Canadian Ed., prepared by K. F. Byrd, (Englewood Cliffs: Prentice-Hall, Inc. 1959), p. 594.

of the combining corporations is accepted, assets, liabilities, and shareholders' equity accounts should be carried over at the existing book amounts. However, if the entities of the combining corporations are not preserved, then the transfer of surplus and indeed the transfer of assets at book value is open to serious question.

Professor Newlove states that three methods are used to accomplish a combination. These are:

> 1. Assets for Securities Plan.
> If Company X, an existing corporation, issues additional shares to Company B for its net assets, and Company B dissolves, giving the stock of Company X as a liquidating dividend, the combination is a merger.
>
> If Company X is organized to issue its stock for the net assets of Company Y and Company Z, and these companies dissolve giving the stock of Company X as liquidating dividends, the combination is a consolidation.
>
> 2. Securities for Securities Plan.
> If Company X, an existing corporation, issues additional stock to the stockholders of Company B for their holdings in the stock of Company B, and then Company B is liquidated as a fully owned subsidiary, the combination is a merger.
>
> If Company X is organized to issue its stock to stockholders of Company Y and Company Z for their stockholdings, and then Company Y and Company Z are liquidated as fully owned subsidiaries, the combination is a consolidation.
>
> 3. Statutory Plan
> This procedure involves the preparation of a formal consolidation plan, the adoption of the plan by security holders having the right to vote, the filing of the articles of agreement with the proper state official, and the exchange of securities through a trustee at a later date.[20]

The distinction as to the type of combinations that Professor Newlove makes is of little importance.[21] Of paramount importance is the fact that in

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[20]G. H. Newlove, Consolidated Statements Including Mergers and Consolidations, (Boston: D. C. Heath and Co. 1948,) pp. 2-3.

[21]Newlove states that; "When one or more existing corporations lose their identity by being absorbed by another corporation, the combination is called a merger if the absorbing corporation was already in existence; and it is called a consolidation if the absorbing corporation is a new corporation organized for that purpose. The term "amalgamation" is sometimes used as a synonym for the term "consolidation'." Ibid., p. 2.

each of the three methods of accomplishing a corporate combination only one of the predecessor corporations survives, or a new corporation comes into existence. All but one of the predecessor corporations disappear in the former situation, and all predecessor corporations disappear in the latter situation.

The above view is consistent with the American Institute's Bulletin No. 48, which states:

> . . . such corporation may be one of the constituent corporations or it may be a new corporation.[22]

Since at best only one of the constituent corporations may survive, the important question is: Can earned "surplus" of a disappearing corporation be transferred to the surviving corporation? Paton and Paton express the following opinion:

> In a transaction in which the acquired company disappears as a corporate entity--there is little justification for the widespread view that the surviving company somehow acquires the retained earnings of the disappearing corporation and may incorporate the amount thereof in its own retained earnings account. The element of the total stockholders' equity represented by income retained in the business has significance only to the entity through which the income was produced; it is literally impossible to transfer this factor in any meaningful sense to any other entity.[23]

This view finds support in England. The Proceedings of the Conference on "The Shortcomings of the Companies Act 1948" held at Oxford in 1958 contain the following:

> It is true to say that the orthodox view still largely prevails that when a company acquires shares in another body corporate the profits relating to those shares which were earned prior to the date of acquisition--termed 'pre-acquisition' profits--are not available for distribution to the acquiring company. This practice is generally thought to exemplify sound accounting principles and

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[22] Committee on Accounting Procedure, op. cit., p. 22.

[23] W. A. Paton and W. A. Paton, Jr., Corporate Accounts and Statements, (New York: The MacMillan Co., 1955), p. 40.

indeed would seem to be accepted by the first part of paragraph 15 (5) of the Eight Schedule (The Companies Act) .... specific exemption, however, from this practice is given in the latter part of paragraph 15 (5) where the acquiring company is a subsidiary of another body corporate and acquires shares either from its holding company or from a fellow subsidiary ....

Where, however, a new company is formed to acquire all the shares of an existing company the exemption given by paragraph 15 (5) does not apply even though the effect of the exercise may be no more than the substitution of one piece of paper for another in the hands of the shareholders.[24]

No official bulletin has been issued by the Institute in England and Wales on the subject of business combination. There is, however, a reference in Bulletin No. N16 regarding pre-acquisition profits as follows:

> In cases where application is made for the quotation of securities of holding companies the department will require to be satisfied that in arriving at any estimate contained or to be contained in any prospectus, offer for sale or public advertisement of the profits of or any dividends to be paid in respect of the first financial year of the holding company due account has been taken of the fact that "pre-acquisition profits" will not be available for distribution.[25]

At a Canadian Institute of Chartered Accountants' Conference in 1959 on "Corporate Mergers and Amalgamations" the concern was primarily with the provisions of the Income Tax Act on the subject. One of the speakers did, however, state that:

" . . . There is no merger of undistributed incomes... "[26] The carry-over of earned "surplus" has won wide support. Some of the arguments advanced for the carry-over of earned "surplus" are as follows:

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[24]The Institute of Chartered Accountants in England and Wales, Proceedings at Christ Church and Merton College, (Oxford, Eng., 1958), pp. 99-100.

[25]The Institute of Chartered Accountants in England and Wales, Recommendations on Accounting Principles, Bulletin No. N.16, p. 5.

[26]W. C. Shakespeare, D. G. Scott, and D. A. McGregor, "Corporate Mergers and Amalgamations, The Canadian Chartered Accountant, LXXVI (February, 1960), p. 176.

> A merger creates no new costs inasmuch as a new basis of accountability does not arise. The aspects of buying and selling are absent as the ownerships are pooled and there is a continuity not present when properties are sold.[27]

Wixon and Kell state:

> . . . It is necessary to exchange shares rather than risk borrowing or incurring the high cost of selling equity securities when one company buys the assets of another. It is also necessary to pay regular dividends to assure a satisfactory market for existing shares, and to develop a reputation which will facilitate future financing operations. In such circumstances the "pooling of interests" concept ignores a legal shell in order to disclose a more fundamental economic entity in its continuing form.[28]

In a corporate combination the ownership is exchanged from ownership in the predecessor companies to ownership in the emerging company. Therefore, although the shareholders of the emerging company may be the same as the shareholders of the predecessor companies, the assets to which they have a claim are not the same.

Continuation of asset costs of the merging companies on the books of the emerging company because "its more conservative" is a poor basis for the practice. Conservatism for the sake of conservatism is not a virtue and more so if the result is to distort economic accuracy. Cost as a basis for stating asset values is applicable only to the company acquiring these assets. However, when the company that in the first instance acquired the assets disappears, the asset costs on the disappearing company's books lose significance. In order to be consistent with "cost=value" at time of acquisition, the assets must be stated at the bargained amount on the books of the emerging company (company taking over the assets of the disappearing companies).

When a corporate combination takes place and the shares are exchanged

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[27]J. A. Carson, op. cit., p. 326.

[28]Rufus Wixon and W. G. Kell, (Editors) The Accountants' Handbook, (New York: The Ronald Press Co. 5th Ed., 1957,) p. 21-48.

on the basis of book values, the book values are usually adjusted prior to the combination.[29] The very fact that the exchange is made on adjusted book values should be sufficient to justify a new basis of the bargained value of the assets of the combining corporations and the process of exchange has all the essential characteristics of buying and selling.

The editors of the Accountants' Handbook would apparently sanction a misstatement of periodic net earnings if this practice would facilitate the payment of regular dividends, assure a satisfactory market for the shares, and develop a reputation which would facilitate future financing. If the arguments cited by the editors of the Accountants' Handbook are to be the reasons for a "pooling of interests" the emerging corporation fails to disclose what the editors refer to as "a more fundamental economic entity." The carry-over of assets at current bargained values would more adequately disclose not only the "fundamental economic entity," but also the proper determination of future net earnings of the emerging entity.[30] With reference to the above, G. O. May states:

> The first objective of any rules applicable in these cases should be to insure the creation of adequate information on which to base charges against revenue in the future. It is now generally recognized that the main importance of monetary ascriptions given to wasting capital assets arises from the fact that they will form the basis of charges against revenues in the future. One corollary that follows is that these monetary ascriptions will be the more significant and useful the more closely they reflect the effective cost to present-day stockholders of their interest in the surviving corporation, rather than the effective cost to stockholders of a prior generation.[31]

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[29]Those in favour of the carry-over of earned "surplus" and deficits apparently sanction a prior adjustment. E. B. Wilcox states: "While such a quasi-reorganization is not a part of the merger transaction itself, I see no valid objection to using this procedure in contemplation of a merger, and, in fact, I think it would be wise to do so." E. B. Wilcox, op. cit., p. 106.

[30]The earnings of the emerging entity could, of course be corrected to reflect the changes in the price level. Price level accounting has not, however, been generally sanctioned by accountants.

[31]G.O. May, op. cit., p. 35.

Continuity of management as a reason for describing a combination as a "pooling of interests" is not valid. Shareholders act in a selfish manner and if the transfer of the new shares will, in their opinion, enhance their individual position, the transfer will be made whether the corporate combination was called a purchase or a pooling of interests. In the same way there is no assurance of continuity of management. The shareholders of the emerging corporation will elect the board of directors which they, the shareholders believe, will best represent them and the board will in turn name the officers of the corporation. There can be no guarantee that the management of predecessor corporations will survive.

Summary

Corporate combinations can be classified into two categories. These are: (1) situations where one of the predecessor corporations survives; and (2) situations where a new corporation is formed to absorb the combining corporations.

In the former all but one of the combining corporations disappear and this form of a combination should be regarded as an acquisition by the surviving corporation. The assets would be recorded at the bargained value and since the earned "surplus" or deficit was that of the disappearing corporation no reason can be found for the carry-over of these items. The ownership in the surviving corporation replaces the ownership in the prior corporation and the manner in which the shareholders' equity was categorized in the disappearing corporation is irrelevant.

In the latter situation all of the combining corporations disappear. The ownership in the new corporation replaces the ownership in the disappearing corporations and the manner in which the shareholders' equity was categorized in the disappearing corporations is also irrelevant.

Where one of the combining corporations survives, the earned "surplus" or deficit of the surviving corporation would be continued. However, where a new corporation emerges, net earnings of the new corporation are pre-requisite for earned "surplus." Arguments against designation of "surplus" in a new corporation are discussed in Chapter III, "The Corporate Surplus."

Evaluation of the Legal Provisions with Regard to Corporate Combinations, The Companies Act, Canada and the Corporations Act, Ontario

The corporate combination or amalgamation procedure is not clearly set out in the Federal Act. In addition, the provision permitting the designation of "distributable surplus" on amalgamation is not desirable. The provision permitting companies to force dissenting shareholders to accept an amalgamation plan when the dissenting shareholders, as a group, constitute less than ten per cent of the outstanding shares is desirable in order that "nuisance" shareholders may not block desirable amalgamations.

The Ontario Act sets out the procedure for amalgamations clearly and provides for the protection of shareholders as well as creditors. No provisions with regard to the carry-over of "surplus" are contained in the Act.

Desirable legislation with reference to corporate combinations should set out clearly the procedure to be followed to effect a combination. The provisions should be such as to protect the shareholders and creditors; however, the companies should be given the right to eliminate dissenting shareholders if the total ownership of dissenting shareholders is less than ten per cent. The Acts should also provide that the new company into which a number of companies combine is not a continuation of the predecessor companies. The latter provision would prohibit the carry-over of earned "surplus."

CHAPTER VI

DISCLOSURE OF CORPORATE ACTIVITY

"Oh wad some power the giftie gie us to see owrselvs as others see us!"[1]

Disclosure of corporate activity should be the province of accountants and not of the government through statutes or through appointed administrative agencies. Intervention by the government on behalf of outside users of data on corporate activity has resulted primarily from the failure of accountants to live up to their obligations. The existence of an obligation to outsiders has been firmly established. Professor Jones states:

> The corporation, through its officers and executives, is entrusted with society's assets: people and goods. It is essential that the corporation report on its stewardship of those assets. Investors and governments must be able to make factually-based investment and regulatory decisions. Those who contribute to corporate existence are entitled to a revelation of performance of corporate administration. The internal affairs of a corporation become vested with a public interest when the firm is owned by thousands and when the livelihood of thousands more rests on successful corporate management. The public--which is society--comes to have a right to know of corporate conduct.[2]

William L. Werntz, Past Vice-President of the American Accounting Association and Past Chief Accountant of the Securities and Exchange Commission states:

> . . . Concurrently, ownership in the form of nonmanagement stockholders and creditors required means of appraising the efforts and stewardship of the management. Such appraisal was originally a basis for either rewarding and retaining or else condemning and changing the active management, but more recently, in the case of large public-

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[1]List of Articles, a Symposium "What's Wrong With Financial Reporting?", The Journal of Accountancy, CXII (August, 1961) p. 2.

[2]G. M. Jones, Electronics in Business, (East Lansing: Bureau of Business and Economic Research, Michigan State University, 1958), p. 8.

ownership companies, has become a basis merely for deciding whether to maintain, withdraw or increase the investment in the particular company.[3]

On the obligation of accountants to investors, George O. May has stated:

The accountant, in addition to his legal and ethical duties, owes his entire practice in the financial reporting field to the investor whose confidence he must secure and maintain.[4]

A society in which the corporate statutes are premised on the idea that their function is to protect the suppliers of capital rather than to provide enabling legislation for the operation of an enterprise in the corporate form, places a heavy burden, in terms of disclosure, on the accountant. Canada is such a society, recognizing the primacy of the suppliers of capital as signified by the following provisions:

The Companies Act, Canada:

Section 122

Subsection 5. The first auditors of the company may be appointed by the directors before the first annual meeting, and if so appointed shall hold office until the first annual meeting, unless previously removed by a resolution of the shareholders at a special general meeting, in which case the shareholders at that meeting may appoint auditors.

Subsection 6. The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues the surviving or continuing auditor or auditors, if any, may act.

Subsection 7. The remuneration of the auditors of a company shall be fixed by the shareholders at an annual meeting or by the directors pursuant to authorization given by the shareholders at the annual meeting, except that the remuneration of any auditors appointed before the first annual meeting, or to fill any casual vacancy, may be fixed by the directors. 1934, c. 33, s. 118.

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[3]Morton Backer (Editor), Handbook of Modern Accounting Theory, (New York: Prentice-Hall, Inc. 1955), p. 105.

[4]Geo. O. May, "The Accountant and the Investor, Ethical Problems of Modern Accounting," summarized in: J.D. Edwards and R. F. Salmonson, Contributions of Four Accounting Pioneers, Kohler, Littleton, May, Paton, (East Lansing: Bureau of Business and Economic Research, Michigan State University, 1961), p. 117.

The Ontario Act is more specific in delegation of appointment of auditors to the shareholders. The Corporation Act, Ontario states:

Section 80

(1) The shareholders of a company at their first general meeting shall appoint one or more auditors to hold office until the first annual meeting, and if the shareholders fail to do so, the directors shall forthwith make such appointment or appointments.

(2) The shareholders shall at each annual meeting appoint one or more auditors to hold office until the next annual meeting, and, if an appointment is not so made, the auditor in office shall continue in office until a successor is appointed.

(3) The directors may fill any casual vacancy in the office of auditor, but while such vacancy continues the surviving or continuing auditor, if any, may act.

(4) The shareholders may, by resolution passed by at least two-thirds of the votes cast at a general meeting of which notice of intention to pass such resolution has been given, remove any auditor before the expiration of his term of office, and shall by a majority of the votes cast at that meeting appoint another auditor in his stead for the remainder of his term.

(5) The remuneration of an auditor appointed by the shareholders shall be fixed by the shareholders or by the directors if they are authorized so to do by the shareholders, and the remuneration of an auditor appointed by the directors shall be fixed by the directors.

(6) If for any reason no auditor is appointed, the Provincial Secretary may, on the application of any shareholder, appoint one or more auditors for that year and fix the remuneration to be paid by the company for his or their services.

(7) Notice of the appointment of an auditor shall be given in writing to him forthwith after the appointment is made. 1953, c. 19, s. 80.

In the delegation of appointment of auditors to the shareholders by both Acts, the Statutes generally set an outstanding example on this continent in positively recognizing that the primary function of corporation Acts is that of protecting the suppliers of capital. Recognizing the rights of the suppliers of capital the statutes have set out the following minimum disclosure provisions:

The Companies Act, Canada

Section 116 (1) At each annual meeting the directors shall lay before the company
(a) a balance sheet made up to a date not more than four months before such annual meeting, but a company that carries on its undertaking out of Canada may by its by-laws extend this period to not more than six months;

(b) a general statement of income and expenditure for the financial period ending upon the date of the balance sheet;

(c) a statement of surplus showing separate accounts for capital surplus, distributable surplus and earned surplus respectively, the amounts of such surpluses respectively at the beginning of the financial period, adjustments affecting previous financial periods, net profit or loss as shown by the statement of income and expenditure, dividends paid or declared on each class of shares stating the account against which the same are charged, any other appropriations, changes in and balance remaining of capital surplus, distributable surplus and earned surplus respectively;

(d) the report of the auditor or auditors; and

(e) such further information respecting the financial position of the company as the letters patent, supplementary letters patent, or by-laws of the company require.

(2) Every balance sheet shall be drawn up so as to distinguish severally at least the following classes of assets and liabilities, namely:

(a) cash;

(b) debts owing to the company from its directors, officers or shareholders respectively;

(c) other debts owing to the company including accounts and bills receivable in such form as to distinguish between current and non-current accounts in all cases in which the estimated loss is not provided for;

(d) inventory, if any, stating the basis of valuation adopted and the manner in which such value has been determined in respect of various sub-divisions of such inventory;

(e) investments and securities, if any, stating their nature and showing the market value of marketable securities, and separately, the book value of other securities;

(f) expenditure made on account of future business, if any;

(g) lands, buildings and plant, stating the basis of valuation, whether cost or otherwise, and, if valued on the basis of appraisal, the date of appraisal, the name of the appraiser, and, if the surplus of the company has been increased as a result thereof, the amount by which the value of such assets has been written up within a period of three years prior to the date of such balance sheet;

(h) the aggregate amount of any outstanding loans under paragraph (d) of subsection (2) of section 15; (loans to employees of the company (directors excluded) for the purpose of purchasing fully paid shares in the company);

(i) debts owing by the company;

(j) liability for taxes imposed by any taxing authority in Canada including amounts owing in respect of such taxes due and payable and amount or estimated amount of the liability for such taxes in respect of the fiscal period covered by the statement of income and expenditure;

(k) the amount of shares of each class issued and outstanding and the amount paid thereon, showing the amount thereof issued since the date of the last balance sheet for services rendered, for commissions or for assets acquired since the date of the last balance sheet for services rendered, for commissions or for assets acquired since the date of the last balance sheet and if any redeemable preferred shares have been issued a sufficient description of such shares to indicate that they are liable to be redeemed;

(l) indirect and contingent liabilities;

(m) the amount or amounts of existing reserves for depreciation, obsolescence and depletion;

(n) the total amount received upon the issue of shares in the capital stock which is attributable to capital;

(o) the total amount received upon the issue of shares in the capital stock set aside as distributable surplus, in accordance with the provisions of subsection (10) of section 12 or otherwise, or any unappropriated balance thereof; and

(p) the total amount of money provided under paragraph (c) of subsection (2) of section 15. (The provision of money by the company for the purchase by trustees of fully paid shares in the company to be held for the benefit of the employees.)

(3) There shall be stated under separate headings in the balance sheet of the company, so far as they are not written off

(a) the preliminary expenses of the company incurred after the first day of October, 1934, or within a period of three years prior to that date;

(b) any expenses incurred in connection with any issue of share capital or debentures; and

(c) if it is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property, the amount of the goodwill, franchises, patents, copyrights, trade marks, leases, contracts and licences as so shown or ascertained and the amount, if any, by which the value of any of such assets has been written up within a period of three years prior to the date of such balance sheet.

(4) Where any liability of the company is secured otherwise than by operation of law or any assets of the company the balance sheet shall include a statement that that liability is so secured, but it is not necessary to specify in the balance sheet the assets on which the liability is secured.

(5) Where any of the assets of a company consist of shares in, or amounts owing, whether on account of a loan or otherwise, from a subsidiary company or subsidiary companies, the aggregate amount of those assets, distinguishing shares and indebtedness, shall be set out in the balance sheet of the first mentioned company separately from all its other assets, and where a company is indebted, whether on account of loan or otherwise, to a subsidiary company or subsidiary companies, the aggregate amount of that indebtedness shall be set out in the balance sheet of that company separately from all its other liabilities, but this subsection does not apply to a balance sheet in which the assets and liabilities of such subsidiary company or subsidiary companies are consolidated with the assets and liabilities of the first mentioned company. 1934, c. 33, s. 112; 1935, c. 55, s. 17.

Section 117 (1) In the case of a company, not being a private company, the statement of income and expenditure to be submitted at the annual meeting shall, subject to the provisions of this section, show as a separate item the total of the amount paid to the directors as remuneration for their services as such directors, inclusive of all fees, percentages, or other emoluments, paid to or receivable by them by or from the company or by or from any subsidiary company, exclusive of the amounts paid to a managing director, if any, or any other director who holds any salaried employment or office in the company and who devotes substantially the whole of his time to the business of the company or its subsidiaries.

(2) The said statement of income and expenditure shall show separately net operating profit before depreciation, obsolescence and depletion and income taxes; income from investments; non-recurring profits and losses including profits and losses of a special nature; amounts written off for depreciation, obsolescence and depletion; amount, if any, written off for goodwill or amortization of any asset; interest on funded or other indebtedness not maturing within one year; reserve for income taxes imposed by any taxing authority in Canada; balance showing net profit or loss for the financial period, but where depreciation, obsolescence and depletion are charged against manufacturing or operating costs by the company in its accounts, net operating profit may be shown after depreciation, obsolescence and depletion, if the amount charged in respect of those items for the financial period is shown as a footnote to the statement of income and expenditure. 1934, c. 33, s. 113; 1935, c. 55, s. 18.

The Corporation Act, Ontario.

Section 82 (1) The auditor shall make such examination as will enable him to report to the shareholders as required under subsection 2.

(2) The auditor shall make a report to the shareholders on the financial statement to be laid before the company at any annual meeting during his term of office and shall state in his report whether in his opinion the financial statement referred to therein presents fairly the financial position of the company and the results of its operations for the period under review.

(3) The auditor in his report shall make such statements as he considers necessary,

(a) if the company's financial statement is not in agreement with the accounting records;

(b) if the company's financial statement is not in accordance with the requirements of this Act;

(c) if he has not received all the information and explanations that he has required; or

(d) if proper accounting records have not been kept, so far as appears from his examination.

Section 83 (1) The directors shall lay before each annual meeting of shareholders,

(a) a financial statement for the period commencing on the date of incorporation and ending not more than six months before such annual meeting, or commencing immediately after the period covered by the previous financial statement and ending not more than six months before such annual meeting, as the case may be, made up of,

(i) a statement of profit and loss for such period,

(ii) a statement of surplus for such period,

(iii) a balance sheet made up to the end of such period;

(b) the report of the auditor to the shareholders;

(c) such further information respecting the financial position of the company as the letters patent, supplementary letters patent or by-laws of the company require.

(2) The statements referred to in subclauses i, ii and iii of clause (a) of subsection 1 shall comply with and be governed by sections 84 to 88, but it shall not be necessary to designate them the statement of profit and loss, statement of surplus and balance sheet.

(3) The report of the auditor to the shareholders shall be read at the annual meeting and shall be open to inspection by any shareholder. 1953, c. 19, s. 83.

Section 84 (1) Every statement of profit and loss to be laid before an annual meeting shall be drawn up so as to present fairly the results of the operations of the company for the period covered by the statement and so as to distinguish severally at least,

(a) the operating profit or loss before including or providing for other items of income or expense that are required to be shown separately;

(b) income from investments in subsidiaries whose financial statements are not consolidated with those of the company;

(c) income from investments in affiliated companies other than subsidiaries;

(d) income from other investments;

(e) non-recurring profits and losses of significant amount including profits or losses on the disposal of capital assets and other items of a special nature to the extent that they are not shown separately in the statement of earned surplus;

(f) provision for depreciation or obsolescence or depletion;

(g) amounts written off for goodwill or amortization of any other intangible assets to the extent that they are not shown separately in the statement of earned surplus;

(h) interest on indebtedness initially incurred for a term of more than one year, including amortization of debt discount or premium and expense;

(i) total remuneration of directors as such from the company and subsidiaries whose financial statements are consolidated with those of the company, including all salaries, bonuses, fees, contributions to pension funds and other emoluments;

(j) taxes on income imposed by any taxing authority and shall show the net profit or loss for the financial period.

(2) Notwithstanding subsection 1, items of the natures described in clauses f, g, and i of subsection 1 may be shown by way of note to the statement of profit and loss. 1953, c. 19, s. 84.

Section 85 (1) Every statement of surplus shall be drawn up so as to present fairly the transactions reflected in such statement and shall show separately a statement of contributed surplus and a statement of earned surplus.

(2) Every statement of contributed surplus shall be drawn up so as to include and distinguish the following items:

1. The balance of such surplus at the end of the preceding financial period.

2. The additions to and deductions from such surplus during the financial period including,

(a) the amount of surplus arising from the issue of shares or the reorganization of the company's issued capital, including inter alia,

(i) the amount of premiums received on the issue of shares at a premium,

(ii) the amount of surplus realized on the purchase for cancellation of shares; and

(b) donations of cash or other property by shareholders.

(3) Every statement of earned surplus shall be drawn up so as to distinguish at least the following items:

1. The balance of such surplus at the end of the preceding financial period.

2. The additions to and deductions from such surplus during the financial period and without restricting the generality of the foregoing at least the following:

(i) The amount of the net profit or loss for the financial period.

(ii) The amount of dividends declared on each class of shares.

(iii) The amount transferred to or from reserves.

3. The balance of such surplus at the end of the financial period. 1953, c. 19, s. 85.

Section 86. (1) Every balance sheet to be laid before an annual meeting shall be drawn up so as to present fairly the financial position of the company as at the date to which it is made up and so to distinguish severally at least the following:

1. Cash.

2. Debts owing to the company from its directors, officers or shareholders, except debts of reasonable amount arising in the ordinary course of the company's business that are not overdue having regard to the company's ordinary terms of credit.

3. Debts owing to the company, whether on account of a loan or otherwise, from subsidiaries whose financial statements are not consolidated with those of the company.

4. Debts owing to the company, whether on account of a loan or otherwise, from affiliated companies other than subsidiaries.

5. Other debts owing to the company, segregating those that arose otherwise than in the ordinary course of the company's business.

6. Inventory, stating the basis of valuation.

7. Shares, bonds, debentures and other investments owned by the company, except those referred to in items 8 and 9, stating their nature and the basis of valuation thereof and showing separately such as are marketable with a notation of their market value.

8. Shares or securities of subsidiaries, stating the basis of valuation.

9. Shares or securities of affiliated companies other than subsidiaries, stating the basis of valuation.

10. Lands, buildings, and plant and equipment stating the basis of valuation, whether cost or otherwise, and if valued on the basis of an appraisal, the date of appraisal, the name of the appraiser,

the basis of the appraisal value and the disposition in the accounts of the company of any amounts added to or deducted from such assets on appraisal after the 30th day of April, 1954, and also the amount or amounts accumulated in respect of depreciation, obsolescence and depletion.

11. There shall be stated under separate headings, in so far as they are not written off, (i) expenditures on account of future business; (ii) any expense incurred in connection with any issue of shares; (iii) any expense incurred in connection with any issue of securities, including any discount thereon; and (iv) any one or more of the following: goodwill, franchises, patents, copyrights, trade marks and other intangible assets and the amount, if any, by which the value of any such assets has been written up after the 30th day of April, 1954.

12. The aggregate amount of any outstanding loans under clauses c, d, and e of subsection 2 of section 23.

13. Bank loans and overdrafts.

14. Debts owing by the company on loans from its directors, officers or shareholders.

15. Debts owing by the company to subsidiaries whether on account of a loan or otherwise.

16. Debts owing by the company to affiliated companies other than subsidiaries whether on account of a loan or otherwise.

17. Other debts owing by the company, segregating those that arose otherwise than in the ordinary course of the company's business.

18. Liability for taxes, including the estimated liability for taxes in respect of the income of the period covered by the statement of profit and loss.

19. Dividends declared but not paid.

20. Deferred income.

21. Securities issued by the company, stating the interest rate, the maturity date, the amount outstanding and the existence of sinking fund, redemption requirements and conversion rights, if any.

22. The authorized capital, giving the number of each class of shares, and a brief description of each such class and indicating therein any class of shares which is redeemable and the redemption price thereof.

23. The issued capital, giving the number of shares of each class issued and outstanding and the amount received there-for that is attributable to capital, and showing,

(a) the number of shares of each class issued since the date of the last balance sheet and the value attributed thereto distinguishing shares issued for cash, shares issued for services and shares issued for other consideration; and

(b) where any shares have not been fully paid,

(i) the number of shares in respect of which calls have not been made and the aggregate amount that has not been called, and

(ii) the number of shares in respect of which calls have been made and not paid and the aggregate amount that has been called and not paid.

24. Contributed surplus.

25. Earned surplus.

26. Reserves, showing the amounts added thereto and the amounts deducted therefrom during the financial period.

(2) Explanatory information or particulars of any item mentioned in subsection 1 may be shown by way of note to the balance sheet. 1953, c. 19, s. 86; 1954, c. 14, s. 15.

Section 87. (1) There shall be stated by way of note to the financial statement particulars of any change in accounting principle or practice or in the method of applying any accounting principle or practice made during the period covered that affects the comparability of any of the statements with any of those for the preceding period, and the effect, if material, of any such change upon the profit or loss for the period.

(2) Where applicable, the following matters shall be referred to in the financial statement or by way of note thereto;

1. The basis of conversion of amounts from currencies other than the currency in which the financial statement is expressed.

2. Foreign currency restrictions that affect the assets of the company.

3. Contractual obligations that will require abnormal expenditures in relation to the company's normal business requirements or financial position or that are likely to involve losses not provided for in the accounts.

4. Material contractual obligations in respect of long term leases,

including, in the year in which the transaction was effected, the principal details of any sale and lease transaction.

5. Contingent liabilities, stating their nature and, where practicable, the approximate amounts involved.

6. Any liability secured otherwise than by operation of law on any asset of the company, stating the liability so secured, but it is not necessary to specify the asset on which the liability is secured.

7. Any default of the company in principal, interest, sinking fund or redemption provisions with respect to any issue of its securities or credit agreements.

8. The gross amount of arrears of dividends on any class of shares and the date to which such dividends were last paid.

9. Where a company has contracted to issue shares or has given an option to purchase shares, the class and number of shares affected, the price and the date for issue of the shares or exercise of the option.

10. The total remuneration of directors as such of a holding company from subsidiaries whose financial statements are not consolidated with those of the holding company, including all salaries, bonuses, fees, contributions to pension funds, and other emoluments.

11. In the case of a holding company, the aggregate of any shares in, and the aggregate of any securities of, the holding company held by subsidiary companies whose financial statements are not consolidated with that of the holding company.

12. The amount of any loans by the company, or by a subsidiary company, otherwise than in the ordinary course of business, during the company's financial period, to the directors or officers of the company.

13. Any restriction by the letters patent, supplementary letters patent or by-laws of the company or by contract on the payment of dividends that is significant in the light of the company's financial position.

(3) Every note to a financial statement is a part of it. 1953, c. 19, s. 87.

Section 88. Notwithstanding sections 84 to 87, it is not necessary to state in a financial statement any matter that in all the circumstances is of relative insignificance. 1953, c. 19, s. 88.

Evaluation of Disclosure Provisions

Compliance with the legal provisions of both Acts produces something less than "full disclosure of material facts." The provisions in fact may have served as guides to companies and auditors as to what is to be disclosed and the form of disclosure. The legalistic view of showing only what the law spelled out has resulted in corporate reporting which: (1) does not meet the minimum recommended standards of the Canadian Institute of Chartered Accountants; (2) reporting which is not consistent with accepted accounting theory, and; (3) reporting which confuses rather than enlightens investors. In support of the above allegations, an analysis of published annual reports of Canadian companies, whose securities are not only listed on Canadian stock exchanges, but in some cases listed on the American stock exchanges, is presented below.

United Grain Growers Limited

The company's statement of consolidated earnings for the year ended July 31, 1961, is an example of reporting which meets only the minimum disclosure required by law. The company fails to meet the recommendation of the Canadian Institute of Chartered Accountants by not disclosing sales and cost of sales for the year. This is the major and most common weakness, from the disclosure point of view of reporting by Canadian corporations. Of the three hundred 1960 published annual reports of Canadian corporations included in the Canadian Institute's study, 210 corporations did not report sales figures.[5]

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[5] The Committee on Accounting and Auditing Research. Financial Reporting in Canada , Fourth Ed., (Toronto: The Canadian Institute of Chartered Accountants, 1961), p. 61.

This is a striking contrast with the 98 percent disclosure of sales by the 600 United States Corporations included in the 1960 edition of Accounting Trends and Techniques.[6]

In the Consolidated Balance Sheet of July31, 1961, the company includes under "Reserves" which are shown above the shareholders' equity the following:[7]

Reserves For		
Deferred taxes on income	$ 2,715,000	
Contingencies and self-insurance	1,500,000	$ 4,215,000

In the shareholders' Equity section of the statement, the company shows:[8]

General Reserve	$ 3,000,000	
Capital Surplus	170,458	
Earned Surplus	4,212,760	$ 12,197,318

In the explanatory notes the following appears:

> The reserves for contingencies and self-insurance increased during the year by $600,000 to the level of $1,500,000. Of this $100,000 was provided out of earnings for self-insurance, following precedent established for the past two years. In addition, $500,000 was transferred to this item for contingencies from the earned surplus account, as already noted, after that account had been augmented by more than $1 million from an insurance recovery during the past year.[9]

In another section of the report the company states:

> . . . The practice was begun in 1958 of making annual appropriations from earnings to an insurance reserve so that when this reaches an adequate amount the company may be in a position to assume a portion of the insurance coverage on country properties.[10]

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6 Ibid., p. 61.

7 United Grain Growers Limited, Annual Report, 1961, p.31.

8 Ibid., p. 31

9 Ibid., p. 11

10 Ibid., p. 5-6

The appropriateness of "reserves" or appropriations of retained earnings was discussed in a prior chapter; attention here is focused on the position of the item "Reserve for contingencies and self-insurance" in the Balance Sheet. The "reserve" is an appropriation of "Earned Surplus" and is identical to "General Reserve" and should be shown as part of the shareholders' equity. In connection with the "reserve" the explanation "the company may be in a position to assume a portion of the insurance coverage on country properties" confuses rather than clarifies the nature of the item. The phrase implies a segregation of assets for the purpose of self-insurance; no such segregation appears on the asset side of the Balance Sheet. Insurance shifts burden of risk of loss to others; with self-insurance there is no shifting of risk of loss to anyone, the company itself assumes all risk, therefore, self-insurance is no insurance.

Dominion Tar and Chemical Company Limited

In the Consolidated Balance Sheet as of December 31, 1960, which does not contain the name of the company in the heading, the company shows in the section captioned "Capital" the following:[11]

	(1960)	(1959)
Surplus resulting from restatement of certain fixed assets - Note 5	$13,900,011	$11,093,731

Note 5 states:[12]

Excess of restated depreciated value over depreciated book value of certain fixed assets (unchanged during year)...	$15,141,969
Net excess of consideration for acquisition of shares of subsidiaries over book value of net assets (after net decrease of $2,806,280 during 1960)...	1,241,958
	$13,900,011

[11] Dominion Tar & Chemical Company Limited, Annual Report, 1960, p.5.

[12] Ibid., p.7.

The company fails to reconcile the amount $11,093,731 shown in 1959 and $13,900,011 shown in 1960.

In the Consolidated Statement of Profit and Loss and Earned Surplus, the company shows the "cost of sales including selling, general and administrative expenses" as one figure. However, more important from an accounting theory viewpoint is the deduction in the "Earned Surplus" section of $675,000 which represents discounts on issue of debentures. The discount on the debentures is an adjustment between the market rate of interest and the coupon rate of interest and should be amortized over the life of the debentures. The unamortized portion of the discount should be shown as a deduction from the related liability. Writing the discount against "Earned Surplus" at the time of issuance of the related debentures has a bearing on the determination of future income. During the life of the debentures the income of the corporation will be overstated in each period by the amount of discount applicable to the period.

Canadian Celanese Limited

The company shows "profit on sale of securities other than Government Bonds" and "Gain on realization of investment in subsidiary companies" in the statement of Earned Surplus for the year ended December 31, 1960, while "Profit on sale of Government Bonds" is shown in the statement of Income and Expenditure for the year ended December 31, 1960. No explanation is presented for the inconsistent treatment of the items. In the company's statement of Income and Expenditure, referred to above, only the minimum disclosure required by law is given. No sales or cost of sales figures are disclosed.

Consolidated Mining and Smelting Company of Canada Limited

In the Consolidated Balance Sheet of December 31, 1960, and in previous Balance Sheets the following appears on the asset side:[13]

Investments and Non-Current Assets:		
Unconsolidated subsidiary companies:	(1960)	(1959)
Shares	$12,290,036	$10,633,307
Bonds	48,600	709,960
Advances	2,955,922	3,629,439
	$15,294,558	$14,972,706
Less accumulated depreciation of investments in unconsolidated subsidiary mining companies	5,577,315	5,577,315
	$9,717,243	$ 9,395,391

No explanation as to how the "accumulated depreciation of investments" was determined is contained in the report or what the item represents. The word "depreciation" is usually associated with physical assets in accounting.

As of December 31, 1957 the company carried in the accounts $87,000,000 designated as "Appropriated Surplus" and $48,043,613 designated as "Unappropriated Surplus" In 1958, $7,000,000 was transferred from "Appropriated Surplus" to "Unappropriated Surplus" and in 1960, $11,000,000 was transferred from "Unappropriated Surplus" to "Appropriated Surplus In a letter dated April 21, 1959 from the Vice-President and Controller of the company, the following explanation appears:

> . . . We are aware that this distinction is not too common. However, as you may know, it has been the policy of our Company to finance expansion out of retained earnings. Consequently, that portion of surplus invested in the Company's undertakings is not presently available for dividends, and we

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[13] The Consolidated Mining and Smelting Company of Canada Limited, Annual Report, 1960, p. 10.

feel that it is logical and more informative to bring out this fact.

In the Consolidated Balance Sheet of December 31, 1959, the following appears between the liability and shareholders' equity sections of the statement:[14]

	(1959)	(1958)
Reserves:		
Insurance	$3,929,381	$3,921,432
Accumulated tax reductions applicable to future years	80,000	380,000
	$4,009,381	$4,301, 432

In the 1960 Balance Sheet the "Insurance reserve" is shown in the shareholders' equity section of the statement where it rightly belongs.

In addition to the items cited the company disregarded the accepted form of the Profit and Loss statement as shown below:

Consolidated Statement of Profit and Loss

For the Year Ended December 31, 1959
With comparative figures for 1958

	1959	1958
Profit from Operations after deducting depreciation and taxes and all expenses of mining, smelting, chemical and fertilizer manufacture, selling and administration	$13,594,387	$11,313,498
Add:		
Dividend from profits of prior years received from a subsidiary company in liquidation	—	23,783
Income from investments	3,107,004	2,446,930
Net profit from sale of securities	2,919	233,432
	3,109,923	2,704,385
Net Profit Carried to Unappropriated Surplus Account	$16,704,310	$14,017,883

The following amounts have been included before determining the profit for the year:		
Provision for income and mining taxes (see note below)	$10,100,000	$ 6,700,000
Provision for depreciation of plant and equipment	9,392,384	9,398,668
Directors' fees and remuneration (excluding for 1959 $440 and for 1958 $440 paid by unconsolidated subsidiary company)	20,873	22,900
Executive officers' fees and remuneration	337,566	311,780
Proportion of total legal remuneration of	119,182	118,186

NOTE: It is estimated that the taxes actually payable for 1959 will amount to $10,400,000. The difference between that amount and $10,100,000 results from transfers of income, for tax purposes only, between years and has been taken into account in determining the balance sheet item "Accumulated Tax Reductions Applicable to Future Years", which represents the net tax postponement at December 31, 1959 from such transfers.

[14] The Consolidated Mining and Smelting Company of Canada Limited, Annual Report 1959, p. 9.

The company is to be commended for altering the presentation of the Profit and Loss Statement in 1960. The excellence of presentation of revenue and expense data ranks with the best of published reports and discloses much more than is required by law.

Although the company has more than met the legal requirements of disclosure, the lack of explanatory notes with regard to the "accumulated depreciation of investments," (2) "manipulation" of the "appropriated surplus" and "unappropriated surplus" accounts; and the form of statements prior to 1960 leave much to be desired from the users of the annual reports.

Blue Crown Petroleums Ltd.

The company's Balance Sheet as of April 30, 1960, appears on the following page.

The company's leases, producing wells and equipment were written up by $955,480 representing approximately a five-fold write-up. Writing up of the assets to the new higher values, at a time when the company is experiencing losses totaling $1,225,842, appears to be a "device" used by the company to "hide" the impairment of "legal capital" that has taken place. In the absence of the revaluation of assets the "legal capital" and the share-holders' equity would be reduced to $396,535.

Although the auditors qualify the report with specific reference to the write-up, the fact that a five-fold write-up of assets is permitted to be incorporated in the published statements may well raise questions as to whether the write-up was designed to obscure the facts of the situation.

BLUE CROWN PETROLEUMS LTD.

(AN ALBERTA COMPANY)

BALANCE SHEET . . . APRIL 30, 1960

ASSETS

CURRENT ASSETS:		
Cash	$ 5,133	
Accounts receivable	4,177	
Prepaid expenses and deposits	788	
		$ 10,098
RECEIVABLE FROM VERMILION CONSOLIDATED OILS LIMITED, an associated company		1,150
DRILLING DEPOSIT		2,455
INVESTMENTS:		
Shares in Vermilion Consolidated Oils Limited, at cost	8,562	
Shares in Cuban Oil Corporation, nominal value	1	
Shares in Blue Crown Petroleum Corporation Ltd., nominal value	1	
Pioneer Syndicate, nominal value	1	
		8,565
CAPITAL ASSETS:		
Leases, producing wells and equipment, at values as appraised by J. E. Renaud, B.Sc., P.Eng., consulting geologist, and reported on under date of May 18, 1960	1,212,725	
Office furniture and equipment, at cost, less accumulated depreciation of $2,940	658	
		1,213,383
COMMISSION ON SALES OF CAPITAL STOCK		114,528
DEFERRED REORGANIZATION COSTS		6,744
		$1,356,923

AUDITORS' REPORT

To the Shareholders of
BLUE CROWN PETROLEUMS LTD.

We have examined the balance sheet of Blue Crown Petroleums Ltd. as at April 30, 1960 and the statement of profit and loss and deficit for the year ended on that date and have obtained all the information and explanations we have required. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances.

In our opinion, and according to the best of our information and the explanations given to us and as shown by the books of the company, the attached balance sheet and related statement of profit and loss and deficit are properly drawn up so as to exhibit a true and correct view of the state of the affairs of the company as at April 30, 1960 and the results of its operations for the year ended on that date, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year, except for the change in recording of the company's investment in leases, producing wells and equipment from cost to appraised values.

Calgary, Alberta,
June 10, 1960.

PRICE WATERHOUSE & CO.
Chartered Accountants.

LIABILITIES

CURRENT LIABILITIES:				
Accounts payable				$ 4,908
SHAREHOLDERS' EQUITY:				
Share capital (Notes 1 and 2) — Authorized — 5,000,000 common shares of a par value of 20 cents each $1,000,000				
Issued —	Shares	Amount		
Balance April 30, 1959	2,493,468	$498,703		
Issued during the year for services	19,200	3,840		
Balance April 30, 1960	2,512,668		$ 502,543	
Capital in excess of par value of issued shares, including $960 relating to shares issued during current year			1,119,834	
Excess of appraised values of leases, producing wells and equipment over the cost thereof less accumulated depletion, amortization and depreciation			955,480	
			2,577,857	
Deficit, per statement attached			1,225,842	
Total Shareholders' Equity				1,352,015
				$1,356,923

SIGNED ON BEHALF OF THE BOARD:

Dr. Gregory Pologrie Director

Tom W. Bentz Director

The notes to financial statements are an integral part of this balance sheet.

Dominion Stores Limited

In the 1957 report the president states:[15]

> Your management has continued its policy of selling store properties when developed and taking back long term leases. The co-operation of leading life insurance companies in this respect has been most gratifying and your Company has commitments from these institutions for the purchase of store properties of approximately $10,000,000.

In the Balance Sheet and in the accompanying notes to financial statements the company fails to disclose the amount of the commitments under sale and lease back arrangements. In the Income Statement, the company fails to disclose separately the amount of the rental expense for the current period.

The failure to disclose a commitment (liability) when the amount is substantial as is the case, is a typical weakness of most Canadian companies with regard to reporting contractual lease liabilities. Although the commitments may be a fixed amount plus a percentage of sales, therefore not determinable; disclosure of the fixed amount of the commitments and the duration of the leases should be the minimum requirement.

In the 1960 report the president stated:

> In the ordinary course of its business, the Company has entered into long-term leases for store properties. The total minimum lease liability under leases extending beyond five years is $47,978,000. [16]

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[15]Dominion Stores Limited, Annual Report, 1957, p. 4.

[16]Dominion Stores Limited, Annual Report, 1960, p. 4.

Although the company has made an attempt to disclose obligations under leases, the statement is not clear as to whether all lease obligations are included or just the leases which do not expire within five years. The disclosure appears to be only partial. With the exceptions noted above, the company's report furnishes much data to aid analysis such as comparative statements and source and application of funds statements.

The reports considered above are, in general, superior in their disclosure to most published reports in Canada. The analysis of these reports does, however, indicate: (1) that disclosure of corporate activity in Canada does not meet the recommended standards of the Canadian Institute of Chartered Accountants; (2) reporting which is not consistent with accepted accounting theory, and; (3) reporting which shows a curious lack of concern, on the part of management, of the fact that the reports are to provide adequate data for investors and other interested parties.

With regard to meeting the legal requirements of disclosure, the following excerpt from an editorial sums up the situation:

> Perhaps the remarkable thing is not the poor standard of reporting, but the relatively high standard. . . in regard to our horse-and-buggy company laws. [17]

Summary

In Canada, auditors are "employees" of the shareholders and, as such, have an inherent duty to protect the interests of their "employers." To the extent that they, the accountants, fail in their duties, legislation is

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[17] Editorial, The Financial Post, February 24, 1962, p. 1.

necessary to assure a minimum standard of disclosure. Voluntary measures taken to insure disclosure are much to be favoured over legislation. Provisions in the statutes are relatively static and tend to be too rigid or too loose and hamper the process of development in accounting. On the subject, Marquis G. Eaton states:[18]

> It would be a great misfortune for American business, and the whole economy, if uniform accounting rules were to be prescribed by government fiat. It would probably mean the end of progress.

Disclosure is relative to the times and must be dynamic in a changing society. In order to be dynamic, the minimum legislative provision that is desirable should read: "Disclosure of corporate activity is to conform to the standards as set out by the Canadian Institute of Chartered Accountants." This is consistent with the view expressed by the Chief Accountant of the Securities and Exchange Commission of the United States Andrew Barr states:

> . . . Regulation S-X does not purport to define accounting principles. It describes the extent of the detailed information required in conventional terminology consistent with present accounting practice.[19]

The role of the Securities and Exchange Commission is to continue to exert pressure on the accounting profession to adopt uniform reporting practices

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[18]Marquis G. Eaton, <u>Financial reporting In a Changing Society</u>, an address delivered before the Illinois Society of Certified Public Accountants June 7, 1957, (New York: American Institute of Certified Public Accountants, 1957), p. 4.

[19]Andrew Barr, "Canadian Accounting and the Securities and Exchange Commission," <u>The Canadian Chartered Accountant</u>, LXXIII (November, 1958), p. 428.

recommended by recognized accounting associations. The role of corporate legislation should be the same e. i., oversee accounting practices in order that the recommended standards of the profession are met.

Implementation of the above recommendation would firmly establish that the accountant is an "employee" of the shareholders and as such is responsible for the disclosure of corporate activity to the "employer." In practice, however, the accountant is not as independent from corporate pressures as would be desirable and a firmer provision is necessary. The addition to the above provision of "and must meet the minimum standards of disclosure required by a prudent investor" is necessary. The "prudent man" rule governing judiciary investments is firmly established and the above provision should lead to the development of a set of standards for corporate reporting by "moral suasion" rather than by legislation. Good accounting cannot be legislated, it must be practiced.

There are really no foolproof rules that can be set forth in law to insure full disclosure; accountants must use their own good judgment, remembering always to act prudently. What is prudent? That is for the court to determine in any particular situation using as a criterion the court's own conception of what financial information about a given corporation a careful, conservative, and competent investor would require in the circumstances given. The prudent rule would serve as the accountant's conscience, insuring adequate disclosure relative to the time and circumstances.

CHAPTER VII

CONCLUSION

Corporate statutes serve a dual purpose. First the statutes serve as enabling legislation for individuals to use the corporate device for the conduct of business, and second, to regulate the corporations to the extent necessary for the maintenance of the respective rights of those who supply the capital for the corporate venture and any others whose rights are affected.

An underlying philosophy of the corporate statutes should be the protection of the rights and interest of investors. The statutes give "life" to the corporation and endow the corporation with certain rights. Among these rights is that the corporation is legally an entity apart from the creditors and owners who have provided the capital with which the corporate unit operates. Because of this incidence of separation of entity, thorough reporting of stewardship becomes imperative if the rights and interests of the suppliers of capital are to be maintained. The corporation is a "child" of the state, therefore, the corporate statutes should be predicated on accountability to those who underwrite the capital needs of the corporate entity. Since accountability is to the suppliers of capital, the statutes should insure that accountability be rendered in the "language" of the suppliers of capital and not in a professional "jargon."

To accomplish the desired accountability the goals of the Acts set out in Chapter I must be attained. To fulfill the goals cited, legal requirements relating to the capital of the corporation, to the corporate surplus and to corporate distributions should be redefined to coincide with sound accounting theory. Disclosure of corporate activity should be redefined by the statutes to require not only conformance to sound accounting theory but also to meet the minimum standards of disclosure required by a prudent investor relative to the times.

The following proposals are set forth as the most desirable to be embodied in the corporate statutes:

The Corporate Capital

A Stated (legal) capital of the corporation should represent the cost (fair value) of all assets received for the benefit of shareholders other than the reinvested earnings which have not been "Capitalized." The sources of stated capital would usually be from shareholders as consideration for shares of the corporation, from gifts or donations to the corporation, and from profitable operation of the enterprise to the extent of retained earnings capitalized.

(1) Where assets received by the corporation are in a form other than cash, the fair market value of assets at time of receipt should be the basis of the credit to stated capital.

(2) When debt securities are converted into shares of the company, the stated capital increase should be measured by the "book value" of debt securities converted on the date of conversion.

(3) Transfers from retained earnings should be permitted only to stated capital. Whether the transfers are accompanied by share issue is of no consequence.

(4) Since indication of the sources of stated capital is usually desirable, disclosure should be accomplished in the shareholders' equity section of the "Balance Sheet" as follows:

Stated Capital:

Invested by shareholders	XXX	
Donations to the corporation	XXX	
Capitalized retained earnings	XXX	XXX

B Where a company has more than one class of shares outstanding, the stated capital attributable to each class should be the total consideration received for the outstanding shares of the class.

C Reduction of stated capital should be permitted where approval is obtained from the creditors and shareholders.

D Adoption of the above proposals would eliminate any need for par or stated value for shares and therefore all shares should be designated as no par shares.

E All companies, regardless of when incorporated and when the shares were issued should be required to comply with updated provisions with regard to stated capital, surplus as well as all other provisions which may have been changed.

The Corporate Surplus

A The corporate surplus should represent the balance of accumulated net earnings reinvested in the enterprise.

(1) Additions to the amount would normally result only from the profitable operation of the enterprise.

(2) Reductions of the amount would result from asset distributions to shareholders and transfers to stated capital.

B If the corporate surplus is negative (deficit), the amount should be carried on the books and shown as a deduction from stated capital in the "Balance Sheet." Elimination of the deficit should be accomplished only through future profitable operation or through the formal reduction of stated capital by an amount equal to the deficit.

Corporate Distributions to Shareholders

A Corporate distributions of assets to shareholders should be identified as to the nature of the distribution.

(1) Distribution of assets representing a division of earnings should be referred to as dividends. A dividend therefore could not exceed the accumulated retained earnings.

(2) Distribution of assets representing a reduction of stated capital should not be referred to as dividends, but should be identified as return of the "permanent" investment.

B "Stock Dividends" are not distributions of assets and should not be referred to as "dividends." "Stock Dividends" represent a pro-rata issuance of shares to shareholders without consideration accompanied by a transfer from retained earnings to stated capital. "Stock Dividends" should be referred to as stock-splits accompanied by a transfer from retained earnings. The amount of the transfer should be left to the discretion of management.

C Distributions to shareholders should be prohibited if the distributions will dissipate the assets of the corporation to a level injurious to the rights and claims of creditors. Specifically, distributions should be prohibited if (1) the corporation is unable to meet the claims of the creditors as these claims become due, and (2) if as a result of the distribution the assets will decrease to an amount which is exceeded by total liabilities.

Corporate Combinations

A Corporate combinations should be accounted for as purchases.

(1) In situations where all but one of the combining corporations disappear, the combination should be regarded as an acquisition by the surviving corporation. Assets acquired by the surviving corporation should be recorded at the bargained value regardless of whether the consideration for the assets was cash, debt securities, or ownership securities of the surviving corporation.

(2) In situations where all of the combining corporations disappear, the new corporation acquires the assets of the disappearing corporations. Assets acquired by the new corporation are recorded at cost, which is fair value.

B Carry-over of "surplus" or deficit from the disappearing individual companies to the surviving or to the new corporation should be prohibited.

Disclosure of Corporate Activity

A Encouragement of voluntary measures to insure disclosure are much to be favoured over legislation. Recourse to legislated provisions should be taken only when voluntary measures have failed. Disclosure must be relative to the times in a dynamic economy and legislated provisions are relatively static.

Standards of disclosure recommended by recognized accounting bodies are current and constantly under review and should serve as the basis for disclosure of corporate activity.

B Recognition of the rights of investors should be made by a provision in the statutes stating that disclosure of corporate activity meet the minimum standards of a prudent investor. This provision would strengthen disclosure requirements in that the "invisible hand" of the courts would be a constant "guide" to accountants and management to report the activity of the corporation in a responsible manner. This provision would not delegate the setting of accounting standards by legal authority as may be feared. The fact that most states where "legal lists" for trust investments were enforced are switching to the prudent man rule should be sufficient proof that the courts are not in favour of specific inflexible rules.

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