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THE SIGNIFICANCE OF CAPITAL SURPLUS TO THE INVESTOR

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The examination of the net worth section of a balance sheet reveals two major parts, namely, (1) the capital stock account and (2) the surplus account. The surplus account is the balancing account which equalizes the difference between the assets, liabilities and capitalization. In this manner the surplus account becomes a reservoir into which are poured increases in net worth and out of which are dipped decreases. Although every transaction of a business either directly or indirectly bears upon the surplus account, corporate accountants and directors have not given enough attention to the proper treatment and handling of this important account. For

> In the minds of the laymen and even of many others who should know better, surplus always implies earned surplus; and to the uninitiated, it even suggests a pile of cash in the back room.[1]

But the idea of surplus is not as simple as this. For the purpose of an intelligent showing on the balance sheet, it is necessary to subdivide the surplus into at least two parts, earned and capital surplus. The definitions given by the American Institute's Committee of Accounting distinguish between the two concepts of surplus as follows: earned surplus is the balance of net profits, net income, and gains of a corporation after deducting losses and after deducting distributions to stockholders and transfers to capital stock accounts.[2] It should be noted that net profits, as defined, constitute the sole source of earned surplus. The American Institute's Committee further describes earned surplus as the accumulation from the date of incorporation or from the date of recapitalization, when a deficit is absorbed by the authorized reduction of the par or stated value of the outstanding stock.[3] Earned surplus is therefore the accumulation of the net earnings which are allowed to remain in the business. This means that its original source is to be found in the current operation of a business enterprise. It can be stated that the main sources of earned surplus are essentially three: (1) net profits from operations remaining at the close of each fiscal period, (2) profits from preceding periods due to adjustments after the books have been closed for the period. Either or both of these may represent losses rather than gains and may therefore subtract from rather than add to already existing earned surplus. Finally, (3) the conversion of reserves no longer needed, which is less common

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1. HOAGLAND, CORPORATION FINANCE 237 (1933).
2. AMERICAN INSTITUTE COMMITTEE OF ACCOUNTING, ACCOUNTING TERMINOLOGY 118 (1931).
3. *Ibid.*

than the other two. When earned surplus has been charged with amounts thought necessary for the various reserves, it is proper to credit surplus with amounts remaining in such reserve accounts after their purposes have been served.

The accounting profession, especially since 1929, has become increasingly critical of the term surplus. An auditor's informative statement should contain a careful analysis of one or more of the surplus accounts, especially if the balances of these accounts indicate important changes during the period under consideration. The purpose of financial statements is not to show merely the surplus available for dividends, but rather to present all the pertinent information essential to an accurate appraisal of the corporation's financial position.

Unfortunately, there is no uniformity in practice as to the terminology of surplus. Most of the statements analyzed, in this review of corporate practice, divide surplus into two and only two categories. One of these is earned surplus and the other is capital surplus. It seems that the more enlightening treatment is to discriminate among the possible sources of surplus. In this manner, the different surplus accounts are carefully distinguished from one another so that each bears evidence of the particular sources from which it came. The differentiation of surplus into a variety of classifications, according to sources, has one serious objection. It has been, and still is, exceedingly difficult, to get the accountants of corporations to divide the surplus into even two classifications of earned and capital. They seem to think that the investor is interested only in the size of the fund available for dividend distribution and not in its origin. The intelligent and thoughtful investor, however, demands to know whether his dividends are a return to him of capital directly or indirectly paid into the corporation, or are profits realized by the corporation in the course of its regular business. Sound investment judgment can be developed only as a result of full disclosures, so far as financial statements permit. From this point of view, full disclosures of the sources of surplus and profits and losses are essential. Once a surplus is obtained, it should be labelled and classified on the basis of the purpose for which it may be used. When it is earmarked, it reveals what it is, where it came from and for what it is intended.

On the basis of the analysis of the balance sheets and profit and loss statements for some six hundred industrial corporations, during the years 1925 through 1947, certain sources of capital surplus were found to have been used consistently by the corporate directors. In the order of importance and frequency, they are as follows:

A. Surplus contributed by investment of stockholders from reductions in capitalization, either by:

1. Reducing capital stock from par to a lower par value or no par value.
2. Changing stated value of no par stock, either by reducing stated value, or changing from no par to a par value less than the stated value.

B. Other sources.

1. From retirement of capital stock and funded debt at a discount.
2. From writing up assets:
   a. Fixed, namely, equipment, building, properties, etc.
   b. Current, namely, inventories and investments.
3. From premium on capital stock.
4. From conversion of reserves.
5. From merger, reorganization, and consolidation.
6. Other sundry and miscellaneous sources.

The creation of capital surplus, from the stockholder's original contributions, has been the most outstanding and prolific source from which corporations have derived capital surplus. This preference has been due to the fact that the capital account has been the largest and easiest manipulated source to which directors could apply. This is true, first, because of the relative ease with which the directors could reason and persuade the stockholders to convert their capital contributions into capital surplus. In the second place, it would be highly illogical, inexpedient and impractical to write up assets during a depression of any length. Asset appreciation is highly improbable in such times; and furthermore, the increased asset valuation would necessitate higher depreciation rates and consequently lower earnings records. In most cases, companies creating capital surplus have been motivated primarily by the desire to make a more favorable earnings record.

Some of the corporations, creating capital surplus from the original capital, have made the conversion so drastic that it practically annihilated the common share equity; as in the example of the drastic write-down of the common stock of the American Home Products Company in 1933, from $17,832,923 to $672,000 thus carrying to capital surplus $17,160,923.

Another well known drastic write-down may be seen in the case of the New York Shipbuilding Corporation, which in 1932 reduced its stock from $12,135,298 to $530,000, carrying $11,605,298 to capital surplus which was used to adjust the book value of securities, and to write down the value of its fixed properties.[4]

In other cases which are common, the creation of capital surplus from the original capital is so slight that the results scarcely affect the financial structure. An example of this type was the very mild adjustment of the

4. MOODY'S INDUSTRIAL MANUAL, 1934.

California Ink Company, which in 1932 reduced its capital stock from $2,067,042 to $1,907,042.[5]

The conversion of reserves, as a source, is limited by the prerequisite of having the necessary reserve on the books to convert. Where merger and consolidations provide a source of capital surplus, a complete reorganization is necessary; consequently, companies delay and avoid this procedure when possible. But where reorganization was deemed expedient and necessary, the participants did not neglect to provide for large capital surpluses in transferring and eliminating balance sheet items.

No profound objection to any particular source of capital surplus can be properly made until one has thoroughly examined the ways in which capital surplus is used. It is largely in consideration of the uses of capital surplus that one can most effectively criticise the source.

In the examination of the six hundred cases included in this study, it has been found that industrial companies utilized capital surplus in the following ways:

1. To write down intangibles.
2. To write down fixed assets.
3. To write down current assets.
4. To wipe out accumulated deficits.
5. To pay dividends.
6. To retire capital stock.
7. To create reserves.
8. To write off depreciation expense.
9. To write off organization expense.
10. Other miscellaneous and sundry uses.

A review of the wholesale revisions in corporate financial structure, occurring during the years 1929-1946, stimulates one's interest in the reasons for these financial reorganizations and readjustments. In the depression years from 1930 to 1935 readjustments, recapitalizations, and the more serious rearrangements of financial structures under reorganizations and reconstructions were outstanding characteristics of corporate financial policy. The particular phase of corporate reorganization which has aroused much comment, has been the recapitalization program pursued by so many of our industrial corporations, especially during the years 1930-1932 and thereafter, when there occurred a virtual epidemic of corporate capital changes.

Various reasons for the readjustment of capital and surplus, as one of the methods for recasting the financial structure of a company, have been offered to the stockholders and outsiders. There are several sources of such information—corporation manuals, financial and accounting journals, and

5. *Ibid.*

corporate reports to stockholders. Correspondence with two hundred of the larger corporations in respect to this subject, revealed that the following reasons are most commonly presented to the stockholders to justify some recapitalization:

1. The creation of a capital surplus is necessitated by general economic conditions.
2. The creation of a capital surplus against which asset values might be written down.
3. The creation of a capital surplus to aid in escaping from some unfavorable contractual obligation or agreement.
4. The creation of a capital surplus against which might be charged:
   a. An accumulated deficit.
   b. Divided payments.
   c. Additional reserves.
5. Supplementary or minor reasons, such as to reduce franchise taxes and stock transfer taxes.

One rarely saw a letter or report from a corporation to its stockholders in which reference was not made to the effect of the existing economic and business conditions of the country on its operations. The depression from 1930-1935 certainly has been accorded its share of the responsibility by corporate directors for many of the corporate recapitalizations. In that period probably more companies were forced into recapitalization than in any other similar period in the history of the country.

In some cases this is probably a true and fair explanation, for even though a financial structure was originally organized to the most approved principles, changing conditions within and without the business may make a different structure desirable at a later date. If conditions change, a recasting of the financial organization may be necessary or desirable.

In spite of this reasonable justification for some of the recapitalizations, it is evident from the letters received from over two hundred industrial corporations that the directors have excused too frequently such capital readjustments by considering such to be advisable in order properly to reflect the drastic changes in industrial conditions which have taken place during the past twenty years.

The most important and usual reason, for the creation of capital surplus, has been the desire to provide a surplus against which to charge reductions in asset values. Of the industrial corporations with whom correspondence was conducted, many indicated that the purpose of the creation of a capital surplus was for a write-down of assets. A typical illustration is furnished by the Borden Company's letter to its stockholders on March 19, 1935. In requesting a reduction of the par values of its stock and a subsequently created capital surplus of $43,967,040, President Milburn said,

> It is the recommendation of your board of directors that the increased surplus, so created through reduction of the aggregate par value of capital stock, be treated upon the books as capital surplus and that against this capital surplus there shall be written off the sum of $21,955,449.14, being the present book value of obsolete plants and equipment no longer used or usable in the business and the amount by which book values of operating properties are in excess of present day practical sound values.[6]

This illustrates one of the ways by which stockholders are induced to create a capital surplus—a very commonly used method during the 1929-1946 period.

In recommending the creation of capital surplus to the stockholders of the Certain-teed Products Company, President George M. Brown made this interesting statement:

> As a result of the write down of $7,184,330 in plant values and the operating losses, a deficit of $9,173,213 has been created on the books. In order to eliminate this deficit, the directors recommend a reduction in the declared value of the common stock to $15.00 per share. This would eliminate the deficit and provide also a capital surplus of $1,713,664, thus retaining a book value of $19.48 per share of common. Such a revaluation does not in any way affect the actual value of the common stock and the directors feel that the resulting elimination of the deficit shown on the books will be advantageous to the corporation and to the stockholders.[7]

And so this company, by the deficit appeal method, was able to persuade its stockholders to reduce the capital stock and create a capital surplus for the write off of its assets.

The two illustrations presented might serve as typical examples of stockholder's letters recommending the creation of capital surplus for the write-down of assets. It is not uncommon to find a letter, however, of the type presented to the stockholders of the Van Raalte Company, in 1933 in which the president said that the stockholders would benefit by the write-down in the following manner:

1. Assets overvalued at $2,245,737 would be written down to a reasonable value of $1,365,310;
2. The company would have its depreciation charges reduced from $255,000 per annum to $122,000 per annum, or a saving of $133,000 per annum;
3. A capital deficit of $423,494 would be changed to a capital surplus of $1,052,245 as of December 31, 1932;

6. *Report to Stockholders of Borden Company*, 1935.
7. *Report to Stockholders of Certain-teed Products Company*, 1930.

4. Dividends could be resumed more quickly on the preferred stock; and
5. The preferred stockholders of the company would be able to sell their shares at a better price.

Though these advantages were specifically offered to the stockholders there was no change in the physical properties, or in the creditors' accounts, or in anything else having a bearing upon the company's operations or worth.

There is a corollary to this situation which deserves some mention. The downward adjustment in fixed assets has served to reduce depreciation and other charges against earnings. This feature has often been advanced as an incentive to the stockholders to write down fixed assets, for lower depreciation charges result in larger earnings and subsequent larger balances for dividends. Probably in many cases write-offs were precipitated to provide for a brighter future earnings record.

Some companies have viewed the depression as an opportune time for the elimination of goodwill, patents, copyrights, and other intangibles of doubtful value. A classical example of this type of write-down is furnished by the Socony-Vacuum Oil Company, in 1934, when the directors recommended a reduction in the par value of stock from $25.00 to $15.00 per share. An excerpt from the letter to the stockholders reads as follows:

> Goodwill and appreciation of properties (including trade names and trade marks) amount to $228,123,580.68. To write off this amount gradually against earnings would, for a long time to come, result in charges against earned surplus otherwise available for dividends and it is felt that this would neither be in the best interest of the stockholders nor conform with good accounting practice. Therefore your directors recommend the reduction of the par value of the capital stock and the immediate elimination of the entire $228,123,580.68 by writing it off against the capital surplus thus made available.[8]

The recommendation was voted and passed, and the items of intangibles thus were charged off. Other notable examples of this type were: the American Ice Company with a write off of $6,586,042.26 in 1933; and Amalgamated Leather Companies with a write off of $5,000,000 in 1933.

Another form of reasoning, particularly effective on stockholders, is that which promises the escape from some burdensome, unattractive, or unfavorable contractual agreement. An examination of the recapitalization plan of the Radio Corporation of America in 1936, the United States Leather Company in 1933, or the American Fruit Growers Company in 1935 will bring out this point clearly. A detailed presentation of each of these plans would require too much space; however, brief mention is made of such notable illustrations.

The Radio Corporation of America in a letter to its stockholders, February 6, 1936, said,

8. *Report to Stockholders, Socony-Vacuum Oil Company,* 1934.

> In its consideration of capital adjustment the primary object of your management and directorate has been to preserve the company's sound financial condition and to eliminate as soon as possible all accrued dividends (which at the end of March of this year will exceed $17,000,000) while placing the stockholders in a position to receive dividends whenever such dividends can be declared without prejudice to the company's development . . . such a capital readjustment, however, should not only make a provision for accrued dividends on the "B" preferred stock and reduce the current preferred dividend requirements, but should also place the holders of the common stock in a position to become the sole beneficiaries of further increases in the company's earnings to be expected in the development of the radio industry which is still in a relatively pioneer stage. The plan of recapitalization which your directors present herewith accomplishes these ends.[9]

The essence of this explanation is that the company would be relieved of a preference charge on earnings of $3,221,000 yearly, namely, the amount due preferred stockholders—ranking ahead the common stockholders. But to add more guile, the first sentence of the letter stated, "that in any consideration of recapitalization the respective contractual rights of all classes of stockholders must be safe-guarded."

The American Fruit Growers Company not only wished to provide for the elimination of a growing accumulation of preferred rights, which on March 31, 1935 amounted to $4,600,000 and the cumulative seven per cent preferred stock; but also to effect a write-down of asset values, to charge off $270,000 of bad debts, and to create a reserve for contingencies of $1,450,000.

The next two reasons convincingly advanced for creating capital surplus probably should be treated jointly, for the creation of capital surplus to eliminate a deficit usually presupposes subsequent dividend payments. As a result of the general economic and business conditions during the years 1930-1935, many companies had incurred operating losses which accumulated on the books as deficits or negative surplus. Many of the respondent companies in this study gave as reasons for their recapitalization, that a deficit on the books had prompted their action. For instance, the Hartman Tobacco Company stated as follows:

> The company had during the start of the year suffered substantial losses, which showed up as a deficit, and reduced the book value of the common outstanding. For this reason we wished our statement to show common stock outstanding at a figure somewhat nearer to its book value and at the same time eliminate the deficit showing.[10]

Many investors and accountants have questioned the use of capital surplus created by the write-down of the capital stock account as a method of eliminating a deficit. They deem it advisable to recoup this deficit out of future earnings. To write off the deficit by this method and then resort to dividend

9. *Report to Stockholders of Radio Corporation*, 1936.
10. *Report to Stockholders of Hartman Tobacco Co.*, 1932.

payments is not wise. All dividends should be paid out of earnings, and losses should be absorbed by future earnings.

The psychological effect of a deficit is bad to the average investor. It harms the corporation, for it fosters the idea of poor management and a poor investment. What could be simpler than recapitalization and a reduction of the legal capital? Some of the reductions have been sufficient only to cancel the accumulated deficit; but the usual practice seems to have been to make a sufficient reduction in capital to replace the deficit by surplus, thus providing for future losses and making more certain the future payments of dividends. The reduction of capital is concerned with the adequacy of future income and the consequent ability either to meet fixed charges alone or to meet fixed charges and share dividends. The adjustment may take either or both of two forms: increasing the income or decreasing the charges. Thus when assets are written down, depreciation charges are reduced, the effect of which, other things being equal, is an apparent increase in net revenue—at least, there is an increase in the amount available to pay dividends. If preferred shares or bonds are directly affected by the recapitalization, the reduction in fixed charges may add also to the income available to the common shares, or conversely reduce the deficit otherwise chargeable against common share equity.

Some corporation managements have, in effect, been forced to maintain dividends on preferred shares because of agreements granting complete or partial control of the corporation to the preferred stockholders, in event certain preferred dividends were not paid. Others have realized that failure to pay cumulative preferred dividends over a period of years would have the same effect on common stockholders as a deficit, by preventing any payment of dividends to common stockholders out of profits until the accumulated preference of the preferred shareholders has been liquidated. In either situation, the reduction of legal capital has provided a convenient means of creating a surplus out of which to pay preferred dividends. The capital surplus, created by a reduction of legal capital, has not been used for dividend purposes. Instead it has been used to absorb all sorts of losses and asset write-downs, thus relieving income and earned surplus of these charges, making possible an earned surplus out of which dividends could be paid. In justification of this practice, it has been argued that losses written off were of a capital nature and not chargeable against current earnings or earned surplus.

The next three and final reasons, namely, to create reserves, to reduce franchise and stock transfer taxes, are of a minor or supplementary nature compared with the foregoing reasons. These are usually offered in addition to the more subtle evasive reasons as an inducement or further incentive to persuade the stockholders to authorize the recapitalization program. Such statements as, "increase in reserves," or "lower charges for franchise and stock transfer taxes result in greater economies," are excellent reading material for the average stockholder.

The American Machine and Metals, Inc., in presenting its reasons for capital adjustments stated that:

> By special survey of fixed assets by Stone and Webster Engineering Corporation your directors have ordered an increase in reserves for bad debts, inventory, obsolescence, investments and general contingencies.[11]

An illustration of the latter two reasons may be found in the 1932 stockholder's letter of Butler Brothers, and the 1933 stockholder's letter of P. Lorillard Company. While in some cases the desire for tax reduction may have been a factor, these transfers to surplus tend to indicate the presence of other motives. These are well indicated by the uses that have been made of the surplus created by the reduction.

There have been situations where it was deemed not particularly imprudent or objectionable to use capital surplus to write down current, fixed, and intangible assets; to create reserves; and to write off prior taxes, reorganization expenses, and other minor miscellaneous and non-recurring expenses. Particularly is this true where receivership and bankruptcy can be avoided only by the elimination of all burdensome items to clear the way for profitable operations. For at the most, asset valuations reflect opinions rather than incontestable facts.

Capital surplus should never be used in a way that would impair the position or favor any particular class of creditors or stockholders over another group. It was seen, however, that capital surplus has often been used to write off accumulated operating deficits in order to pave the way for immediate dividend payments. Such dividends, paid directly or indirectly out of capital surplus, are really a return of part of the original capital contributions of the stockholders. Though the average stockholder is led to believe that such payments represent distributions of earnings, he does not fully appreciate that his capital investment is being returned to him in the disguise of dividends. Such practices should be firmly criticized and rebuked, and the investor should shun any company pursuing such a policy. The advisability of paying dividends from such a source is questionable, since in effect a distribution of this kind is a return of capital. The laws of the state in which the corporation is organized may make it illegal for a corporation to pay dividends from surplus thus created. In several states the corporation must inform the stockholders from what source dividends are paid if the payment is

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11. *Report to Stockholders of American Machine & Metals, Inc.*, 1932.

not made out of earnings. Such a procedure, of course, is advisable even when not required by law.

Another important point should be made in reference to the maintenance of adequate junior capital. Junior capital is an indispensable condition for any sound fixed value investment. A bond issue or loan cannot be wisely made to a business, unless that business is worth a considerable amount over and above the amount borrowed. This fact should be well understood. But to the average investor it is not generally known that corporation laws permit the withdrawal of substantially all the capital and surplus after the bonds have been issued. This can be done legally by reducing the capital to a smaller amount and paying the difference to the stockholders as dividends. As a result, the stockholders have recovered most of their capital with the cash supplied by the bondholders. But the stockholders retain ownership and control of the business, with the right to receive all profits above the rate paid to the bondholders. The bondholders are in the position of having provided all the capital and having assumed all the risk of loss, without any share in the profits above ordinary interest. Bondholders, placed in this position, have not been treated fairly, but apparently this can be done legally unless the indenture of the bond issue has specifically prevented it by stipulating that no payments could be made to the shareholders that would reduce the capital and surplus below a certain amount. There should be provisions prohibiting dividends or other distributions to the stockholders unless there is an adequate margin of resources above the indebtedness. Some of the latest safeguards in new bond indentures provide that the reduction of stated capital is prohibited and that the surplus is frozen at the time of the bond issue. It should be clear that these contractual provisions are essential to the proper safeguarding of a bond issue. The large issuing houses and intelligent investors should insist on their inclusion in all indentures.

Until the 1936 Revenue Act[12] was passed, one could justly condemn the use of capital surplus to eliminate operating deficits. But during the period while this innovation in public finance and taxation was in effect, a different attitude had to be taken in regard to the elimination of deficits by the use of capital surplus. In fact, it was a matter of business expediency for companies showing a sizeable current operating profit, with an embarrassing deficit on the books, to create a surplus to wipe out this deficit, and pave the way for either a cash or stock dividend payment, in order to obtain the allowable credit deductions in computing the tax on undistributed net income. In addition to this, the Act virtually prohibited the use of earned surplus for capital expansion. Furthermore, no relief was afforded those unfortunate companies which operated at a loss and incurred heavy current indebtedness

12. 49 STAT. 1652, 1655 (1936) (repealed in 1942).

during the years from 1930 to 1936, and which desired to use their cash to stave off their pressing creditors. Instead of using cash to pay creditors, these companies were forced by the 1936 Revenue Act to use their cash either for dividend payments, or increased income tax and surtax payments (unless they preserved it through the use of stock dividends, which was, however, a questionable policy).

If this taxing statute had continued in its original form, radical changes would have had to be made in the financial policies of corporations. During its brief life, the undistributed profits tax was sharply criticized by business interests. The main arguments against the tax were as follows: The tax ignored the importance of surplus and reserves in corporate finance. It was contended that too little attention was given to financial stability or to the ability to withstand economic shocks which arises from a general strengthening of the owner's equity in the corporation. If earnings are retained in the business, protection is acquired against unexpected losses arising from business conditions or other causes. Not only does the stockholder acquire a margin of protection for his investment, but protection is also given to the company's creditors and to the economic system. Failures can often be avoided when concerns have made adequate reserve provisions during good times to meet the exigencies of depressions which are likely to follow, and society gains to the extent that unnecessary failures are avoided.

Another argument against the tax was the failure to make provision for previous deficits. If a concern has had a number of years of operating deficits, as would be especially likely to occur in a new company, there is good argument for permitting it to retain part or all of later income to absorb the accumulated deficit and to restore the capital to its original position. In fact, most state laws prohibit the payment of dividends so long as invested capital is impaired. Yet, under the original undistributed profits tax, no credit for previous deficits was permitted.

There was no distinct tendency for companies in a strong cash position to repurchase their capital stock during the period from 1930 to 1936. Such a policy has not only afforded the companies an opportunity to use their idle cash balances, but also provided a bountiful source of revenue to those companies repurchasing their stock, discounted because of the depressed securities market. During the 1930-1936 depression, repurchases of their own shares were made by many industrial companies out of their surplus cash assets. Figures, published by the New York Stock Exchange in February, 1933, revealed that two hundred and fifty-nine corporations with shares listed thereon had acquired portions of their own stock. The stock was purchased in the open market without giving any information to the stockholders. The plan followed by the corporations brought a number of unwholesome elements into the situation, although it was thought to be in the interest of the corporation to purchase the stock at the lowest price. The outcome of this plan was that those stockholders who sold their shares back to the company were compelled to take as large a loss as possible, for the presumable benefit of those who held their shares. Although this is a proper viewpoint to follow in purchasing other kinds of assets for the business, there is no warrant in equity for applying it to the acquisition of shares of stock from the company's own stockholders. The corporation is more obligated to act fairly toward the sellers, because the company is itself on the buying side.

If a corporation has surplus funds that it does not need for expansion purposes or for the retirement of funded debt, instead of allowing such funds to lie idle, it should use them to retire securities senior to the common equity. For example, if it has no bonds outstanding but has several classes of preferred stock retireable on call at a premium, such funds may conceivably be used to retire such preferred issues. But in all events, the common stock should retain its identity as a trust fund and should not in any event be purchased by the corporation.

There is an urgent need for the universal adoption by all corporate bookkeepers and accountants of some standard procedure for handling all surplus transactions, with particular emphasis on proper classifications and nomenclatures regarding the respective sources, and a proper, sensible and equitable utilization thereof. As it stands now, because of the great diversity of opinion and treatment of capital surplus on the balance sheet, the account has no universal or definite significance.

It is true that some progress has been made in this connection. The first step toward uniform accounting took place in 1934 when the Securities Exchange Act was passed. The purposes of the Act were twofold: First, to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate commerce and through the mails and, second, to prevent inequitable and unfair practices on such exchanges and markets. The Act was based upon the fact that such actions so affect national public interest as to necessitate regulation and control.

The provisions of the Act are significant for the investor in industrial securities because they place the full force of the Federal Government behind the Act to assure investors of adequate corporate financial reports. The fulfillment of this aim, however, will require a period of development. As Commissioner Landis of the Securities and Exchange Commission said in a speech before the Economic Club of Chicago,

> Uniform corporate reporting is not a matter that can be obtained over night. It is an end that must be worked for patiently in industry, with the cooperation of industry. No one who has even superficially glanced at the methods of corporate reporting in vogue

today can help but feel the prevalence of such divergence that is almost akin to anarchy. For the benefit of all, some one must be trusted to try slowly but persistently to bring order and rationale into this phase of our corporate life.[13]

The Securities and Exchange Commission took the first step in this direction when, on December 20, 1934, it announced permanent rules for the registration of securities traded in on stock exchanges. The rules contained three outstanding requirements: (1) establishment of certain accounting principles in financial statements; (2) details of compensation to be paid the management and directors; and (3) disclosure of gross sales. The adoption of more uniform accounting principles involved more detailed income statements and balance sheets, and additional information necessary in the evaluation of securities. Although the Commission declared that uniform accounting principles had not been absolutely established, the rules stated that earned surplus must be set apart from capital or paid in surplus, the market price as well as the book value of marketable investments must be shown in the balance sheet and the company's or its affiliate's securities must not be classified as marketable securities.

After a proper audit, certification by public accountants was required for financial statements; but the Commission provided for no standard form of certification. The accountant was required, however, to explain his method of work and especially to point out matters that called for attention. He was particularly required to single out treatment of items concerning which he may have been in disagreement with the corporation's officers. The significance of the Commission's rules lies in the fact that it did not seek to establish a uniform system of accounting for all corporations, but rather to set up a uniform standard to be met by various systems.

The industrial type of business organization should attain some degree of uniformity justified by experience of the accounting profession in the railroad industry. It must be realized, however, that in the case of railroad accounting one deals with businesses having the same basic operations. Practically all transactions are alike and as a result a set rule can be made which applies with the same significance to all these transactions. But in the industrial field, one deals with many different types of businesses. Nevertheless, it is evident that in the consideration of uniform accounting for industry as a whole, or for individual industries, we face a definite fact, that is, certain financial elements are sufficiently alike in their characteristics to justify uniform presentation. But other financial elements are not because of the different types of business. Hence, a certain set of rules cannot be adopted to cover all phases of accounting relating to industrial activities. Uniformity is a sound principle to follow only in those cases where there exists a similarity in basic

13. Speech of Securities and Exchange Commissioner Landis before the Economic Club of Chicago, reported in the Wall Street Journal, June 11, 1934.

elements. The success of the principle of uniformity in railroad accounting has caused the Government to try to adopt a similar principle in the field of industrial accounting.

The Securities and Exchange Commission, with its rules and regulations affecting only those corporations whose stock is listed on the organized exchanges or sold in interstate over-the-counter markets, has succeeded in developing some uniformity in accounting practice among industrial corporations. The filing of reports, statements, and facts to this Commission must be prepared according to certain rules and forms. As already indicated, this procedure of course has its limitations because it affects only those industrials that have their stock listed on the security exchanges. Corporations which are exempt from the Commission's regulation comprise, however, the larger number of all businesses in the industrial field. It is this latter group which has made little or no progress in the development of uniform accounting procedures. It would be well indeed if the control of the Securities and Exchange Commission could be extended to include this group also.

It must be realized that business is constantly changing, that it is subject to recurring conditions of expansion and contraction. A burden of responsibility rests upon the shoulders of the management to provide for the rainy day in the intelligent administration of assets and earning power and through conservative dividend policies. In order to meet this responsibility the directors should maintain a conservative rate of dividend payments year after year. A reserve for dividends should be set up, the purpose of which is to provide sufficient funds to maintain conservative payments in good and bad years. If expansion of the business must take place, a greater part of the earnings will have to be ploughed back into the property, equipment and staff. A reserve for expansion should therefore be set up. Then, too, many unforeseen situations arise in business that make it necessary for the company to have realizable assets readily available. For example, if a reserve for contingency is set up, the corporation will be aided through a difficult period. If this is not done, then the corporation may be forced to correct its mistakes by resorting to decapitalization. It should not be inferred, however, that decapitalization or devaluation does not have some legitimate and sound uses. Among these uses are:

1. The elimination of the deficit on the balance sheet growing out of declines in the general price level and from the errors of previous management.
2. Accumulated arrearages in dividends and burdensome future requirements on preferred shares may be eliminated.

As has been pointed out, stockholders should realize the evils inherent in voluntarily agreeing to a plan of devaluation and decapitalization. They should, before agreeing to this plan, demand and receive rightfully the following:

1. Adequate compensation for the surrender of their prior rights which they may have previously enjoyed.
2. Adequate information as to the reasons, purposes, results, and the need for devaluation and decapitalization.
3. Assurance that the prospects are bright for a recovery of earning power independent of any artificial bookkeeping methods.
4. Reasonable assurance that, the continuation in power of the existing managment, will not repeat the same errors.

The problem of controlling corporations in the interest of the investor and the public is not simple nor easy. There are probably three ways that this may be done. The first is by uniform state codes. This would accomplish much. In the United States, we have forty-nine different laws governing the corporations. In other countries, such as England, there is only one corporation law for the entire country. The right to grant charters to ordinary business corporations was not given to the Federal Government in its Constitution; rather this power was impliedly reserved by the various states. Despite the fact that corporate charters are granted by the different states, the large corporations commonly transact both an interstate and intrastate commerce business in many states. But they are still governed by the laws of the state of their formation, and in the case of corporations which are qualified in foreign states, by additional laws which may be applicable in such jurisdictions. A state is limited in its control over foreign corporations in transactions involving interstate commerce with its residents, because the Federal Government, through its power to regulate such business, will protect the corporation. But one state has no control over the laws adopted, or the corporations formed, in another state. As has been noted, many corporate practices are permitted in some states which are not allowed in others. If the states could get together and adopt a uniform code, this would aid in bringing about the means of control needed.

A second means of control over the corporations could be developed as a result of a federal incorporation law. Such a law would eliminate both the competition which exists among the states to secure fees from the chartering of corporations, and the tendency toward more and more laxity in the laws. Since corporations located in one state would be governed by the same law as those in other states, it is probable that this law would give better protection to stockholders and creditors than do the laws of many of the states.

The various states, however, because they would stand to lose an important source of revenue, do not favor the federal incorporation of companies. There is also doubt as to the constitutionality of laws passed by Congress for the formation of ordinary business corporations. Many individuals would oppose federal incorporation because of the fear that too much power would thereby be vested in the Federal Government.

It is probable that the substitution of federal incorporation laws, for those of the states, is still far remote. But it is submitted that a plan of this type of control would be a workable one.

The third means of regulating corporations would be through the Securities and Exchange Commission. Any interstate corporation that has stock and bonds outstanding could be made to comply with certain rules and regulations. The Commission has this power now, but it only regulates the corporations whose stock is listed on the exchanges or sold in interstate over-the-counter markets. It has the power to make rules and regulations affecting securities as follows:

1. To make rules and regulations, including those governing registration, statements and prospectuses.
2. To interpret accounting, technical, and trade terms used in the Act.
3. To issue stop orders suspending the effectiveness of registration.
4. To secure from courts injunctions restraining violations of the Act and mandamus authority to compel compliance with its provisions.

The fundamental doctrine of the Securities Act of 1933 is that full disclosure regarding new issues and the continuing disclosure of the affairs of privately owned companies must be given. The public should thoroughly understand that the Commission is not authorized to pass in any sense upon the value or soundness of any security. Its sole function is to see that full and accurate information, as to the security, is made available to purchasers and the public and that no fraud is practiced in connection with the security, and that the issue bears the earmarks of legal decency. Speculative securities may still be offered and the public is as free to buy them as ever. If capital surplus is shown on the balance sheet its source must be given. If devaluation of the capital takes place, all this information must be fully given to the stockholders including statements as to its use.

The idea of regulation of securities does not prevent unwise investments but it gives assurance of adequate and full information. Only financing of a fraudulent nature falls under the clear ban of the law. The customary assumption is that adequate disclosure will enable the investor or speculator to reach his own decision. In practice, however, a powerful body like the Securities and Exchange Commission can prevent many issues from reaching the public that are deemed of very doubtful character, by burdening the corporations with delays and costs and by an insistence upon a very full statement of factors that are likely to make for a poor sale of the issue, such as the details of a poor earnings record and financial condition.

There is no substitute in regulation, however, for the development of good management and a sense of moral responsibility on the part of those in charge of the conduct of the financial affairs of our great privately owned corporations. Because stockholders and bondholders can be made to bear the mistakes and unscrupulous acts of managements by many different methods of juggling the surplus account of the corporation, it should be clear that those who direct the fortunes of these economic empires must and should recognize their position of trusteeship and take account of the interest of all investors and the public, as well as of the particular class of investors who have the power at the annual meeting.

Finally, this whole problem of corporation finance is fundamentally important to the public. It is basic in our present economic system. Corporations must be regarded as socially useful institutions, and those who control them must have a high degree of social responsibility. There is no gainsaying the fact that the corporation stands pre-eminent among business organizations as an institution for the economic employment of society's saving.