CORPORATE ACCOUNTING AND THE LAW*

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The corporate abuses and financial excesses of the 1920's showed the need for stricter statutory and accounting control over numerous corporate practices. Since 1930 the legislatures of practically all of the states have either adopted entirely new corporation acts or have substantially amended the existing acts. Unfortunately there is much less uniformity among these new laws than might have been hoped for, either as to the abuses dealt with or as to the methods adopted for curing them. Furthermore, while some awareness of accounting principles here and there is evidenced, by and large relatively little consistent accounting theory manifests itself.

It would appear that on the whole the accounting profession has done a more constructive job than that done by lawyers and legislative draftsmen in laying down new rules for corporate conduct. The American Institute of Accountants, in the publication of its various Research Bulletins, the National Association of Railroad and Utilities Commissioners, in its recommended Uniform Systems of Accounts for electric and gas utilities which have been widely adopted in substance by state utility commissions and by the Federal Power Commission, the work done independently by the larger accounting firms, and the close relationships maintained by them with the accounting staffs of administrative and regulatory commissions, have all contributed toward the production of reasonably workable and reasonably uniform accounting standards for corporations. Differences of opinion seem to relate more to the application of a particular accounting rule to a particular set of facts than to the correctness of the rule itself.

It goes without saying that accounting requirements can never cut below statutory minimum requirements but as a practical matter it is seldom that a statutory provision will be found to be more restrictive than the accounting rule. On the contrary, a corporation or its counsel, when the accountants are called in,

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may be rudely awakened to the fact that things are not what they legally seem and that the accounting policy involved is something quite different from the legislative policy.

Although the several matters hereinafter discussed bear, for the most part, no necessary relationship with one another, all of them involve problems of practical present-day application and, moreover, problems the answers to which are by no means wholly settled as to either their legal or accounting aspects.

Treatment of Financing Expense in Connection with the Issuance of Shares

A statutory provision such as that contained in section 21 of the 1943 Missouri Corporation Act[1] presents a number of interesting questions. That section reads:

> The reasonable charges and expenses of organization or reorganization of a corporation and reasonable compensation for the sale or underwriting of its shares may be paid or allowed by such corporation out of the consideration received by it in payment for its shares without thereby rendering such shares not full paid and nonassessable.

Generally speaking, a sale of shares to underwriters for public offering by them may be handled on a so-called spread or discount basis or on a compensation basis. The first of these two bases contemplates the sale of the shares by the corporation to the underwriters at a specified price with a resale by the underwriters to the public at a higher price, the difference representing the spread or the discount. When, on the other hand, the compensation basis is used, the price paid by the underwriters to the corporation for the shares and the price at which the shares are offered by the underwriters to the public will normally be the same, the corporation agreeing to pay to the underwriters a fixed price as compensation for their commitment and for their undertaking to effect a distribution of the shares. While the two methods will of course produce exactly the same dollar result, both to the corporation and the underwriters, there may be circumstances making necessary or advisable the use of one method rather than the other notwithstanding the fact that the differences between the two methods may be more apparent than real.

If the shares to be sold by the corporation are to be first offered

1. Mo. Rev. Stat. § 351.170 (1949).

to stockholders for pro rata subscription, with an agreement by underwriters to purchase and publicly offer the unsubscribed shares, the compensation basis, rather than the spread or discount basis, should be employed. At least this is true if by law or by charter the stockholders have pre-emptive rights since in that case the corporation could not sell the unsubscribed shares to the underwriters at a price less than that at which the shares had been offered to the stockholders for subscription. As a practical matter, even in the absence of pre-emptive rights the compensation basis should be used for the reason, if for no other, that knowledge on the part of the stockholders that the price payable by them was greater than that payable by the underwriters for the unsubscribed shares would operate as a psychological deterrent to subscriptions. One may well say that this is specious reasoning, both from the legal standpoint where pre-emptive rights have been granted and from the practical standpoint where such rights have not been granted, since the difference between the spread and compensation bases is seemingly one of form rather than of substance. Nevertheless a legal point is often saved and a practical problem often solved by resort to a form that gives the least emphasis to whatever doubts may inhere in the situation.

If, in the case of an underwritten issue of shares not involving an offering to stockholders, the shares to be issued are par value shares and are to be offered by the underwriters to the public at par, the question arises as to the proper method of dealing with the underwriting discount or commission, having in mind that in practically all states, including Missouri, par value shares may not be issued by the corporation for a consideration less than their par value. The provision of the Missouri Corporation Act referred to (and there are similar provisions in other jurisdictions[2]) states that reasonable underwriting compensation may be paid *or allowed* out of the consideration for the shares without thereby rendering the shares not full paid. Under the wording of this provision could a corporation safely contract with underwriters for the sale to them of $100 par value shares at $98, for public offering at par, thus providing a $2 per share spread to the underwriters? Could it be held that for the pur-

2. *E.g.*, ILL. REV. STAT. c. 32, § 157.20 (1951); MICH. COMP. LAWS §§ 450.18-450.19 (1948); WIS. STAT. § 180.17 (1951).

poses of the statute the consideration to be received by the corporation was in reality $100 per share and that out of such consideration the underwriters were to be "allowed" $2 per share? It would be more difficult to contend that the underwriters were to be "paid" any amount out of such consideration. The question has not as yet been squarely passed on by any reported decision of a Missouri court or of a court of any other jurisdiction. Pending judicial determination, the more conservative course would be to provide in the underwriting contract, in the case supposed, for payment by the underwriters to the corporation of $100 per share and payment by the corporation to the underwriters of compensation in the amount of $2 per share. In this particular case it should make no real difference, apart from the legal implications, whether the spread or discount plan on the one hand or the compensation plan on the other is followed, the net amount receivable by the corporation being the same in either event. However, where no par value shares are being issued or par value shares are being sold at a premium, the accounting treatment required in respect of the underwriting discount or compensation may, as will later be mentioned, suggest the use of the spread basis rather than the compensation method.

In passing it may be noted that the Missouri statutory provision under consideration permits in effect the capitalization of expenses of organization or reorganization (not limited to underwriting expenses) but, in the case of the sale of shares, provides for the capitalization of underwriting compensation only. The reason for this distinction is not clear.

So far as the Missouri statute is concerned, the problem heretofore discussed is not present in the case of the issue of no par value shares unless, however, the corporation wishes to establish a certain stated value for the shares and in that connection desires to capitalize the underwriting expense.

We come now to the matter of the accounting treatment of underwriting and other financing expense. While section 21 of the Missouri Corporation Act provides for the effectual capitalization of underwriting compensation (whether or not it so provides with respect to underwriting discount or spread), there are situations in which such capitalization is not permitted by applicable accounting rules.

To digress for a moment, attention is called to the fact that

there is no provision in the Missouri Act which expressly permits the charging of underwriting or other expense of financing against paid-in surplus, whether previously created or created by the sale of the shares being underwritten at a price in excess of their par value in the case of par value shares, or in the case of no par value shares, by an allocation to paid-in surplus of a part of the consideration received for the shares. The 1933 Illinois Corporation Act, after which the 1943 Missouri Act was patterned, originally contained no provision for charges of such character against paid-in surplus, but in 1949 the Illinois Act was amended so as to provide expressly for the charging against paid-in surplus of "expenses, including commissions, paid or incurred by the corporation in connection with the issuance of its shares."[3] At the same time the definition of "paid-in surplus" was amended accordingly. The term is now defined to mean all that part of the consideration received by the corporation for, or on account of, all shares issued which does not constitute stated capital, less, among other things, "expenses, including commissions, paid or incurred by the corporation on account of the issuance of such shares."[4] A means is thus provided by the Illinois Act whereby, unless objection is made by the accountants, a corporation having sufficient paid-in surplus can protect its earned surplus against charges on account of stock financing expense.

Statutory provisions to the contrary notwithstanding, it seems clear under the Uniform Systems of Accounts, recommended by the National Association of Railroad and Utilities Commissioners (and which, incidentally, have been substantially adopted by the Missouri Public Service Commission for certain utilities subject to the Commission's jurisdiction), that a corporation the accounts of which are required to be maintained in accordance with one of the Uniform Systems can neither capitalize commissions and expenses in connection with issuance of stock nor charge them off against any account other than earned surplus. The recommended Uniform Systems of Accounts provide, under various account numbers, that separate accounts shall be kept for discount, expense, and premium on capital stock; that expenses applicable to capital stock shall not be added to capital

3. ILL. REV. STAT. c. 32, § 157.60a (1951).
4. ILL. REV. STAT. c. 32, § 157.2 (1951).

stock discount nor deducted from premium on capital stock; that in stating the balance sheet, discount and expense and premium shall not be set off against each other; and that such discount and expense may be charged, in total or in installments, to the account Miscellaneous Debits to Surplus, or may be retained in the account Discount on Capital Stock or in the account Capital Stock Expense, as the case may be, subject to amortization through charges to the account Miscellaneous Debits to Surplus. This is the first illustration of the fact that accounting requirements may in a particular case be found to be more restrictive in nature than the corresponding requirements of law.

As to accounting with respect to stock financing expense in the case of a corporation not subject to the jurisdiction of a governmental agency that has adopted a Uniform System of Accounts, it is understood that the accountants, in the absence of special circumstances, will not object to a statement of the accounts in accordance with statutory authorization and will not necessarily insist on the application of rules analogous to the provisions of the Uniform Systems. An industrial company or other non-regulated corporation should not, however, be too surprised if, on the filing of a registration statement with the Securities and Exchange Commission, it should discover that the Commission would accelerate the effectiveness of the registration statement only on the condition that expenses incident to the financing be accounted for in the manner prescribed by the Uniform Systems.

Before leaving the subject of financing expense, it is noteworthy that the application of the provisions of the recommended Uniform Systems of Accounts to a situation in which no par value shares are being issued or par value shares are being issued at a premium *may* produce a result unlike that obtained where par value shares are publicly offered at par. We have seen that in the latter case, under the Uniform Systems, the underwriting spread, or the discount below par, cannot be capitalized and that the underwriting expense, when taking the form of compensation to underwriters, must be charged to earned surplus. But suppose that the shares being issued are no par value shares or that par value shares are being offered by underwriters at a price sufficiently above par to cover the agreed underwriting discount or spread without reducing the price to

the corporation below par. In these circumstances if the underwriting contract is set up on the spread basis it would seem that under the Uniform Systems of Accounts the amount to be capitalized would be the actual amount received for the shares by the corporation and that there would be no charge in any amount to surplus. On the other hand, if the contract should provide for an offering by the underwriters at the same price as that payable by them to the corporation and for the payment of stated compensation by the corporation to the underwriters, the Uniform Systems would apparently require the capitalization of the full public offering price and, in addition, would require the charging of the underwriters' compensation to surplus. So here is one situation at least in which the corporation can exercise some control over its capital and surplus accounts simply by selecting the right technique in providing for the underwriters' profit.

Stock Split-ups and Stock Dividends

So much has been written and said regarding legal and accounting considerations incident to stock split-ups and stock dividends that some reluctance is felt in undertaking further discussion here. The justification, however, may be that the variance among the states in pertinent statutory provisions and the lack of complete unanimity of opinion as to the accounting principles to be applied are such as to make the subject one of continuing interest.

Legally, and ignoring business concepts, the difference between a stock split-up and a stock dividend is clear.

A stock split-up is simply a division of outstanding shares with no attendant change in stated capital. In the case of par value shares the per share par value will necessarily be reduced but the aggregate par value of all shares will remain the same; and in the case of no par value shares the split-up will result in a lesser per share stated value but with no change in aggregate stated value. In the true stock split-up, surplus will in no event be transferred to capital account. A split-up of shares constitutes a recapitalization to be effected by charter amendment authorized by the stockholders.

A stock dividend consists of the pro rata issuance of additional shares to holders of the outstanding shares with no new consid-

eration therefor moving to the corporation, but accompanied by the transfer of a certain amount from surplus to stated capital. The declaration of a stock dividend, including the determination of the amount of surplus to be transferred to capital, is ordinarily by action of the directors only. From the legal standpoint, a stock distribution of this kind, whether it be a 5% or a 500% distribution, is still a stock dividend and not a stock split-up.

The technical stock split-up, involving no change in the capital or surplus account, presents no accounting problems whatever. A stock dividend, on the contrary, always entails an accounting decision as to how much surplus, and sometimes what kind of surplus, is to be transferred per share to stated capital. As we shall see, this accounting determination will in certain cases be made quite independently of statutory requirements.

The objective of a stock split-up commonly is to secure a broader market for the corporation's shares. A change of 100,000 outstanding shares with a market price of $100 per share into 400,000 shares with a market price of $25 per share will place the stock within the reach of a wider class of investors, with a corresponding impetus to trading interest. A stock distribution in the form of a stock dividend may, if substantial, have the same effect but usually to a lesser degree since such a distribution will necessitate the freezing of a part of the surplus against future distribution as dividends whereas no such freeze occurs in connection with a stock split-up.

A stock split-up or the distribution of a stock dividend is often effected, for the purpose of reducing per share market price, in anticipation of public stock financing. Experience shows that in a steady market the per share price, after the split or distribution, will frequently be at a level somewhat above the mathematical level indicated by the split-up or distribution ratio. Also, stockholders and investors may expect, or at least hope, that the dividend rate per share will be reduced somewhat less than ratably. These circumstances suggest that in the event of a stock split-up or stock dividend care should be taken to see that stockholders and investors are advised of the exact nature and effect of the transaction and, if it consists of the distribution of additional shares as a dividend, that the amount of surplus to be transferred to capital be determined in accordance with such

accounting principles as will not tend to deceive existing and prospective holders of the corporation's shares.

A corporation the shares of which carry a high dividend rate, in dollars, may split the shares or pay a substantial stock dividend for the purpose also of reducing the dollar amount of the dividend to a more modest figure. While this is mere window-dressing it may nevertheless serve to allay criticism by persons who fail to understand that the dollar amount of the dividend per share is significant only as it represents a certain rate of return on the investment. The nine dollar dividend of American Telephone and Telegraph Company is constantly being assailed as though it were a nine per cent rate whereas in fact, at the current market price of the stock, it is less than six per cent.

In the past the issuance of stock dividends has been the subject of considerable abuse, economically if not legally. Particularly in the 1920's, corporations which were unable or unwilling to pay or to continue to pay cash dividends frequently resorted to the device of periodic stock dividends capitalized on a basis bearing no reasonable relationship to the stated value or actual value of the outstanding shares. Such corporations were, in a way, simply pulling themselves up by their own bootstraps. The only limitation generally imposed by state corporation laws as then in effect was that par value shares issued as a dividend be capitalized at not less than par. This limitation afforded no real protection when the outstanding shares were selling substantially above par, and where the shares were without par value there was usually no prescribed minimum at all as to the amount per share to be transferred from surplus to capital in connection with the dividend.

Few, if any, of the state corporation acts in effect in that former period expressly prohibited the capitalization for stock dividend purposes of unrealized appreciation in value of assets, and it was all too common practice among cash-impoverished corporations, desiring to maintain a good front with their stockholders, to write up assets and to charge stock dividends against the book surplus thus created.

The earlier state corporation laws uncommonly, if at all, required disclosure to stockholders, in connection with the payment of a stock dividend, of the amount per share transferred from surplus to stated capital. Under the circumstances re-

viewed, it was entirely natural that stockholders should be misled as to the effect and worth of the stock dividends which they received. While the informed stockholder should always understand that a stock dividend does not increase the over-all value of his investment, nonetheless should he not be entitled to assume that the dividend represents earnings per share in an amount reasonably related to the value of the shares which he originally held or, if not, should he not at least be so advised when the dividend is paid?

The provisions of the 1943 Missouri Corporation Act relating to stock dividends[5] do not go very far toward the prevention of abuses associated with such dividends. The usual provision that par value dividend shares shall be capitalized at par is preserved but, as has been pointed out, this may not help much in the case of relatively low par value shares. As to no par value shares, the matter is still wide open except as to a stock dividend payable in preferred shares, which rarely occurs, in which case it is required that there be transferred from surplus to stated capital an amount equal to the involuntary liquidation price of the preferred shares issued. Apparently the surplus against which the charge is to be made cannot in the case of any stock dividend be paid-in surplus, the only express provision as to the use of such surplus for dividend purposes being that it may be applied to the payment of dividends identified as liquidating dividends. The Missouri statute is silent as to the use of appreciation surplus as a basis for stock dividends and presumably such use would not be considered lawful. At any rate the accountants would not ordinarily approve the charging of a stock dividend against such surplus. The corporation acts of Minnesota[6] and California[7] expressly forbid stock dividends against unrealized appreciation in value of assets while Illinois,[8] Ohio[9] and Pennsylvania[10] permit them, at least by implication. The Missouri Act, like many of the modern corporation acts, does provide that when no par value common shares are issued as a dividend the amount per share transferred to stated capital shall be dis-

5. MO. REV. STAT. § 351.220 (1949).
6. MINN. STAT. § 301.22 (1949).
7. CAL. CORP. CODE § 1505 (1947).
8. ILL. REV. STAT. c. 32, § 157.41 (1951).
9. OHIO CODE ANN. § 8623-38 (Baldwin 1940).
10. PA. STAT. ANN. tit. 15, § 2852-703 (1938).

closed to the stockholders concurrently with the payment of the dividend. On principle, that same disclosure might well have been required in the case of par value shares in view of the fact that par value in many cases will be less than the actual value of the outstanding shares.

In the last decade the American Institute of Accountants, the New York Stock Exchange, and the Securities and Exchange Commission and other regulatory bodies have done some realistic thinking on the subject of stock dividends and related questions of accounting. Although their views differ in some of the particulars, they all seem to regard the statutory safeguards provided by most state laws as inadequate. In general they take the position that when the underlying purpose of a stock dividend is to effect, in theory, a distribution of earnings, the amount of surplus to be capitalized should not be left to the unlimited discretion of the directors, regardless of whether the shares to be distributed are par value or no par value shares, but should be fixed at an amount geared to the value of the outstanding shares. If, on the other hand, the distribution of the shares as a stock dividend is mainly for the purpose of increasing the number of outstanding shares, the distribution, while in legal effect a stock dividend, will be looked upon as a stock split-up to which the accounting requirements for stock dividends will not be applied. Before taking up the exact nature of these requirements, we should better understand just when, from the accounting standpoint, a stock dividend is not a stock dividend but is a stock split-up.

The New York Stock Exchange has adopted an arbitrary line of demarcation, based solely on the percentage of the distribution. If it is less than 100% the Exchange ordinarily requires that the distribution be treated as a stock dividend for accounting and other purposes and, conversely, if the distribution is 100% or more the Exchange will normally not permit it to be designated as a stock dividend. The Securities and Exchange Commission has also declined to allow such a distribution to be described in a registration statement as a stock dividend, saying that such a designation is "distasteful." The approved terminology is, "A stock split-up, effected in the form of a stock dividend."

The accountants do not, it is understood, subscribe to the hard

and fast 100% test invoked by the New York Stock Exchange, but take the broader view that the matter is essentially one of business intent as evidenced by all of the circumstances. For example, when stock dividends are of relatively small percentage, and especially when they are being paid periodically, it is easy enough to say that they are intended to represent distributions of earnings and hence are true stock dividends. Here the same end result is achieved as would be effected by the declaration of cash dividends accompanied by a forced reinvestment of the earnings assumed to have been distributed. If the stockholder wishes to receive cash he can sell his dividend shares.

The statement has been made by certain members of the accounting profession that in the case of a relatively small stock dividend, say less than 30%, the presumption should be that a dividend is intended and that rather conclusive evidence to the contrary should be required to negative the presumption. While this is not the equivalent of saying that anything over 30% may, even prima facie, be regarded as a stock split-up, it does indicate a more liberal position than that taken by the New York Stock Exchange.

As the percentage of the distribution becomes higher and particularly when the distribution is non-recurring in nature, it can obviously be more readily held to be a stock split-up, in the business meaning, not requiring any special accounting treatment. It is suggested that if the primary purpose of the distribution is to increase the number of shares outstanding as in the case of a legal stock split-up, designation of the distribution as a stock dividend in the resolution of the board of directors and in communications to stockholders should be avoided.

Assuming that a distribution is to be treated for accounting purposes as a stock dividend and not as a stock split-up, what are the rules for determining the amount of surplus per share to be transferred to stated capital? The American Institute of Accountants in its Research Bulletin No. 11 states, in effect, that the amount should be the greater of the ratable per share amount of the combined capital stock and capital surplus accounts, before the stock dividend, and the per share fair market value of the then outstanding shares. In practice this formula may not always be rigidly adhered to by the accountants. The statement of the formula rather indicates that the fair market value re-

ferred to is fair market value at the time of the declaration of the dividend. A better measure would seem to be, and in fact it has been often used, average market value of the corporation's shares during the period in which the earnings being capitalized were accumulated. In any event some attention should be given to the range of market prices over the period if price fluctuations have occurred. Also, the view has been expressed that the value formula should be modified by adjusting market value to take into account the increased number of shares to be outstanding after the stock dividend or, in other words, that such value should be determined pro forma.

The New York Stock Exchange adopted, in 1948, the proposals contained in Bulletin No. 11 of the American Institute of Accountants. The rule of the Exchange prior thereto was that the amount to be charged against surplus should be the higher of fair value and net tangible asset value.

If the shares of the corporation proposing to pay the stock dividend have no established market value, other value factors must of course be taken into account in fixing the per share amount of surplus to be capitalized, including book value and average earnings over a reasonable number of years, capitalized at a proper rate.

The 1947 California Corporation Act[11] and the Minnesota Act,[12] as now effective, each provide that for stock dividend purposes common shares without par value shall be valued at their estimated fair value at the time of issue and that surplus shall be charged accordingly, but leave par value shares and no par value preferred shares to be valued at par and at involuntary liquidation price, respectively, without regard to fair value. The 1947 Oklahoma Corporation Act,[13] however, goes the full distance and adopts the fair value basis for all stock dividend shares, whether par value or no par value. The present Michigan Act provides that dividend shares without par value shall be valued at an amount equal to "the average original consideration per share of the shares without par value outstanding at the time of such declaration which is carried as capital."[14] The Califor-

11. CAL. CORP. CODE § 1506 (1947).
12. MINN. STAT. § 301.22 (1949).
13. OKLA. STAT. ANN. tit. 18, § 1.135 (Supp. 1952).
14. MICH. COMP. LAWS § 450.22 (1948).

nia[15] and Oklahoma[16] Acts each require that upon the declaration of a dividend payable in shares of any kind notice shall be given to the stockholders of the amount per share transferred from surplus and of the particular surplus from which transferred.

With the exception of California, Minnesota and Oklahoma, notably Oklahoma, it must be concluded that comparatively little has been accomplished in the way of bringing state corporation laws into line with modern accounting theory as to the accounting treatment to be accorded stock dividends.

Stock Dividends Received by Parent Corporation from Controlled Subsidiaries

Since the decision, in 1919, of the United States Supreme Court in *Eisner v. Macomber*[17] it has been generally accepted that as a legal proposition stock dividends do not constitute income to the recipient. That case dealt only with the taxability of such dividends under the federal revenue laws. Following this decision, there was added to the revenue laws the provision[18] that a distribution made by a corporation to its shareholders in its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

Although there have been a few state court cases holding stock dividends to be income for the purposes of state income tax laws or for certain other limited purposes, it must be recognized that the strongly prevailing legal theory is against the treatment of stock dividends as income to the recipient. Most state corporation laws contain provisions relating to the payment of stock dividends by a corporation but do not, at least as a rule, make provision as to the treatment of such dividends in the hands of a recipient corporation. Probably the only occasion for such provision would be in connection with the inclusion or exclusion of the dividend stock as an asset of, or income to, the recipient corporation in the determination of its ability to pay cash dividends to its own stockholders.

Consistently with the legal theory pertaining to stock dividends, Research Bulletin No. 11 of the American Institute of

15. Cal. Corp. Code § 1506 (1947).
16. Okla. Stat. Ann. tit. 18, § 1.134 (Supp. 1952).
17. 252 U.S. 189 (1920).
18. Int. Rev. Code § 115f (1).

Accountants states, regarding the accounting principles as to the corporate recipient:

> (1) An ordinary stock dividend is not income from the corporation to the recipient in any amount.
>
> (2) Upon receipt of such a dividend, the cost of the shares previously held should be allocated equitably to such shares and to the shares received as a stock dividend.

In the discussion of these accounting principles, the Bulletin continues:

> The income of the corporation is determined as that of a separate entity without regard to the equity of the respective stockholders in such income. Under conventional accounting procedure, the stockholder has no income solely as a result of the fact that the corporation has income; the increase in his equity through undistributed earnings is no more than potential income to him.

The New York Stock Exchange has adopted literally the accounting principles stated in Bulletin No. 11.

The question is not specifically dealt with by the Uniform Systems or Accounts recommended for utilities by the National Association of Railroad and Utilities Commissioners. The account entitled "Dividend Revenues" merely states: "This account shall include the revenues derived by the utility from dividends on stocks of other companies."

The rule that stock dividends received by a person or corporation not in control of the payor corporation may not be considered income to the recipient is not, presumably, open to serious question either from the legal or the accounting point of view. In the absence of control, the stockholder has no right of election as to whether he takes his dividends in cash or in stock. In the absence of control, it is impossible to justify the treatment of stock dividends as income on the basis of an analogy to the results reflected by a consolidated income statement. In *Eisner v. Macomber* the taxpayer was not in control of the payor corporation.

As a matter of law, if strict regard is to be had for the separate entity concept, it is difficult to justify the treatment of stock dividends as income even if the recipient is in control of the payor. As a matter of accounting, however, the case may stand differently. A corporation owning 51% or more of the stock of another corporation is in a position to exercise an absolute

choice as to whether the earnings of the subsidiary be paid out in cash or in stock. If the earnings are needed in the business of the subsidiary, the parent has two courses, one, to take up the earnings in the form of cash dividends and then reinvest the cash in stock or obligations of the subsidiary, or, alternatively, to take up the earnings in the form of stock dividends, leaving the cash with the subsidiary for direct application to its own uses. If the latter course is adopted, the parent corporation does directly that which it would do indirectly by following the cash dividend-reinvestment procedure. Under these circumstances should not the stock dividend be considered as the equivalent of a cash dividend reinvested, with an appropriate crediting of the earned surplus or income account of the parent corporation and a corresponding charge to its investment account? Many accountants are today saying "Yes".

The question has become one of great practical importance in recent years. Since the end of World War II, corporations, and particularly public utility systems, have undertaken and are still engaged in large construction and expansion programs, often necessitating, where parent-subsidiary situations are involved, the financing of the subsidiary's requirements, in whole or in part, by the parent corporation. If these requirements are met by the reinvestment by the parent in the subsidiary of cash dividends paid by the subsidiary, the parent corporation, under present federal income tax laws, incurs a tax liability in respect of 15% of the cash dividends received by it. If, however, the subsidiary retains its earnings for direct investment in its own plant and issues stock dividends to the parent against the capitalization of such earnings, no federal income tax liability accrues to the parent corporation.

A corporation, with one or more subsidiaries, however anxious it may be to realize this tax saving, ordinarily cannot afford to do so unless stock dividends paid by the subsidiaries can be taken into the income or earned surplus account of the corporation for purposes of payment of cash dividends by it, and unless also, in the case of regulated public utilities, such stock dividends can be made the basis for the issuance by the parent corporation of its own securities. Subject to appropriate limitations, it is submitted that on principle the position of the parent corporation with respect to the payment of cash dividends to its own stock-

holders and, if a public utility, with respect to the issuance of its securities should be the same, regardless of the form, cash or stock, in which dividends are paid to it by its subsidiaries.

If this proposition, however, is to be accepted, all accountants would agree that, as a minimum requirement, the stock dividend of a subsidiary not be taken into the income account of the parent at an amount greater than that charged by the subsidiary to its income or earned surplus account in connection with the payment of the dividend, and that no part of such charge represent income of the subsidiary earned prior to the acquisition by the parent of the stock in respect of which the dividend is paid. In short, there should be complete synchronization between the accounts of the subsidiary and those of the parent corporation for all purposes.

The American Institute of Accountants Bulletin No. 11, in further discussion of its stock dividend rule, states:

> It is recognized that this rule, under which the stockholder has no income until there is a distribution, division or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries, or in the case where the stockholder is given a bona fide option to take cash or stock.

The New York Stock Exchange, in its published Statement on Stock Dividends, has not expressly stated its recognition of any exception to the rule that stock dividends are not income, but it is reasonable to assume that whenever reputable accountants, in the case of a parent corporation whose stock is listed on the Exchange, recommend the treatment as income on the books of the parent of stock dividends received from subsidiaries, the Exchange will go along.

The Midwest Stock Exchange impliedly accepts the propriety of this treatment by the inclusion in the form of agreement, required to be entered into with the Exchange by listed companies, of a provision to the effect that the company will not take up, and will not permit any controlled subsidiary to take up, as income, stock dividends received at an amount greater than that charged against earned surplus by the issuing company in connection with the dividends.

The accounting staff of the Securities and Exchange Commission has said that in the case of a parent public utility corpora-

tion, not subject to the Commission's jurisdiction under the Public Utility Holding Company Act of 1935,[19] no objection will be raised to the showing of subsidiary stock dividends as income on the income statement of the parent corporation contained in a registration statement filed under the Securities Act of 1933,[20] provided that such showing has been approved by a state utility commission having jurisdiction and, further, that appropriate explanation be set forth in the notes to the financial statements. The Commission has, however, indicated a reluctance to permit this treatment in the registration statement of a parent industrial company.

The Securities and Exchange Commission has issued, under the Public Utility Holding Company Act of 1935, a uniform system of accounts for utility holding companies, one provision of which unqualifiedly prohibits the taking up by a holding company, as income, of stock dividends received by it from its subsidiaries.

We are all familiar with the practice in the 1920's and early 1930's, particularly of some public utility holding companies and investment companies, of causing their subsidiaries to issue stock dividends capitalized at nominal amounts, and in no way representing true earnings of the subsidiaries, and then taking up such dividends in their own income accounts at the market value of the outstanding stock of the subsidiaries or at some other unrealistic figure.

The provision in the Commission's uniform system of accounts for holding companies was designed to put a stop to this practice. Unfortunately, the Commission has, up to the present time, been quite insistent on the application of this provision even though the circumstances of particular cases are not of the character of those which prompted the adoption of the provision in the first instance. If stock dividends of the subsidiary are capitalized at fair value, as good accounting practice now requires, and are taken up as income by the parent in an amount not greater than the amount so capitalized, there is no legitimate accounting reason for the arbitrary application of the stock dividend provision of the Commission's uniform system. There have been a few cases in which the Commission has, in effect, made some

19. 49 STAT. 803, 15 U.S.C.A. §§ 79-79z-5 (1951).
20. 48 STAT. 74, 15 U.S.C.A. §§ 77a-77aa (1951).

departure from the rule, but on the whole the situation of holding companies subject to the Commission's jurisdiction under the Public Utility Holding Company Act is not very satisfactory as regards stock dividends of their subsidiaries.

Reverting to the question of the legality of cash dividends paid by a parent corporation out of earned surplus comprising stock dividends of a controlled subsidiary, it has previously been mentioned that state corporation acts generally do not expressly deal with the matter, and there appears to be no court decision passing upon the exact point. Nevertheless, if all of the accounting limitations are observed and responsible accountants have certified the income or surplus statement, with subsidiary stock dividends included in income or earned surplus, and cash dividends are paid by the parent corporation on the basis of the income and surplus accounts so stated, it is reasonable to believe that an informed court would hold such dividends to be lawful.

Reference has also been made to the problem with which a regulated public utility is confronted when it wishes to realize the federal income tax saving made possible by taking up subsidiary earnings in the form of stock rather than cash dividends, and at the same time wishes to preserve the basis for the issuance of its own securities which it would normally have if cash dividends were paid and the cash reinvested in the subsidiary for use by it for the construction or acquisition of property additions.

The Missouri Public Service Commission Act,[21] like many other state public utility acts, provides that a gas, electric or water corporation may issue securities, with the consent of the Commission, for, among other things, the acquisition of property or for the reimbursement of moneys actually expended from income for such purpose. When the controlling parent utility takes up the earnings of a subsidiary through cash dividends and thereafter applies the cash to the purchase of stock, notes or other securities of the subsidiary, it clearly has made an "expenditure" for "property" against which securities of the parent are issuable. When the parent corporation, in order to save federal income taxes, takes up the subsidiary's earnings in the form of stock dividends, has it not also made an expenditure for the acquisition of property? It seems not too unreasonable to say that

21. MO. REV. STAT. c. 386 (1949).

it has. The stock itself may be regarded as property, and consideration should also be given to the fact that when the subsidiary expends the cash, in lieu of which its stock dividends have been issued, for property additions, physical property, on a consolidated basis, has actually been acquired. In this connection it is helpful if the cash retained by the subsidiary is earmarked and held subject to the condition that it will be used only for plant additions. It may be somewhat harder to say that in receiving a stock dividend from a subsidiary the parent corporation has made an expenditure of any kind. But here again, we should look at the substance and not at the form. If the parent, being in control of the subsidiary and having an absolute election as to the form of the dividends paid by the subsidiary, whether in cash or in stock, causes the subsidiary to issue stock dividends, the parent thereby, by its own action, foregoes the receipt of cash which, also by its own action, it could have caused to be paid to it. Such voluntary relinquishment of the right to receive cash should constitute in practical and legal effect an expenditure for the purposes of statutory language such as that used in the Missouri Public Service Commission Act. The position of both the parent and the subsidiary after the payment of a cash dividend and the reinvestment of the funds received in additional stock of the subsidiary is exactly the same as it is after the issuance of a stock dividend. A utility commission should not force the companies to go through the mechanical motions of exchanging checks simply to satisfy technical statutory terminology and thus deny to the parent corporation, its stockholders and customers, the advantages of the federal tax saving. It is encouraging to note that utility commissions in some of the states are beginning to accept this view.

Earned Surplus of Constituent Companies in Mergers and Consolidations

Section 70(g) of the Missouri Corporation Act[22] provides:

> The aggregate amount of the net assets of the merging or consolidating corporations which was available for the payment of dividends immediately prior to such merger or consolidation, to the extent that the value thereof is not transferred to stated capital by the issuance of shares or

22. Mo. Rev. Stat. § 351.450(7) (1949).

otherwise, shall continue to be available for the payment of dividends by such surviving or new corporation.

The Illinois Act[23] contains an identical provision and similar provisions are contained in the corporation acts of Michigan,[24] Ohio,[25] Pennsylvania,[26] California[27] and Nevada.[28]

The effect of the Missouri provision is to permit, in the case of a merger, the earned surplus of the merging corporation to be carried forward on the books of the surviving corporation and, in the case of a consolidation, the taking into the accounts of the new corporation of the earned surplus of the constituent corporations, all without regard to the economic factors underlying the particular transaction. The word "permit" is used notwithstanding the fact that the statute says "shall". Clearly the word "shall" ought to be construed as directory merely and not mandatory.

The accounting theory, in opposition to the provision of the Missouri Act, has been that where a substantially new business enterprise results from the merger or consolidation there is no possible basis for preserving in the accounts of the surviving or new corporation the earned surplus of the non-surviving merging company or of the consolidating companies, that in such a case the merger or consolidation does not differ in effect from an outright purchase by one corporation of the assets of another, and that earnings, as such, cannot in the nature of things be purchased separate and apart from the assets as a whole.

On the other hand, if the merger or consolidation represents simply a pooling of interests and the continuation of essentially the same business enterprise, though in enlarged form, there is very substantial accounting support for the preservation of the earned surplus of the constituent corporations. This type of transaction is spoken of as an "economic merger," the term being applied to a consolidation as well as to a merger, regardless of the legal distinction. In fact, there have been cases in which the accountants have been willing to apply the economic merger theory to a transaction in which X Company acquires,

23. ILL. REV. STAT. c. 32, § 157.69(g) (1951).
24. MICH. COMP. LAWS § 450.53 (1948).
25. OHIO CODE ANN. § 8623-67 (Baldwin Supp. 1952).
26. PA. STAT. ANN. tit. 15, § 423 (Supp. 1951).
27. CAL. CORP. CODE § 4117 (1947).
28. NEV. COMP. LAWS § 1638 (Supp. 1949).

in exchange for its own stock, all of the stock of Y Company, followed by the dissolution of Y Company, no legal merger or consolidation being involved at all. And in at least one case of this kind the Securities and Exchange Commission, for purposes of the financial statements included in a registration statement, has gone to the same length, although historically the Commission has been averse to the inclusion in the surplus accounts of the surviving or new corporation of surplus on the books of the non-surviving merging corporation or of the consolidating corporations immediately prior to the merger or consolidation.

Whether a certain transaction constitutes an economic merger or the creation of a new enterprise is, from the accounting viewpoint, a question almost wholly of fact. Similarity in character of the businesses being put together, continuity of management, continuity of stockholders' interests, and economic justification in general are obviously all factors supporting the economic merger theory.

It has been said that if these factors are not present in sufficient degree, a revaluation of the assets of the constituent corporations must take place, thus establishing a cut-off or new starting point, that such revaluation will necessarily include undistributed earnings of the constituent corporations, and that therefore the issuance of the new securities of the surviving or new corporation on the basis of the valuation will result in the capitalization of such earnings, precluding their addition to the earned surplus account of the surviving or new corporation. Conversely, it has been stated that if the factors tending toward business continuity are strong enough to justify the survival of earned surplus they should at the same time be considered sufficiently effective to make unnecessary the recognition of new values.

Corporations not subject to the jurisdiction of a regulatory agency, in adopting a plan of merger or consolidation under laws like the Missouri Act, cannot of course be estopped, by accounting principles or otherwise, from providing, if they desire, for the survival of earned surplus. If the accountants object, their only recourse is to qualify their certificate and to include in the notes to the financial statements such statements as they consider appropriate.

As a concluding generalization it is suggested that the public interest would be served if lawyers could know more about accounting and accountants more about law, and if lawyers were more often consulted in the formulation of accounting rules and accountants participated more actively in the drafting of our state corporation laws, all with the objective of securing greater harmony as between the legal and accounting concepts relating to corporations.