A Study of the Principles Used in the Classification of the Owners' Equity Section of the Balance Sheet.

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A STUDY OF THE PRINCIPLES USED IN THE CLASSIFICATION
OF THE OWNERS' EQUITY SECTION
OF THE BALANCE SHEET

A Dissertation

Submitted to the Graduate Faculty of the
Louisiana State University and
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in partial fulfillment of the
requirements for the degree of
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in

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by

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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACKNOWLEDGMENTS ........................................... ii</td>
</tr>
<tr>
<td>LIST OF TABLES ........................................... v</td>
</tr>
<tr>
<td>ABSTRACT ..................................................... vi</td>
</tr>
</tbody>
</table>

## Chapter

### I. INTRODUCTION ............ 1

- Problem of the Study
- Purpose and Scope of the Study
- Theory of Classification
- Organization of the Study

### II. THE NATURE OF THE BALANCE SHEET AND OWNERS' EQUITY ............. 13

- The Multiplicity of Balance Sheet Concepts
- Equity Theories
- The Valuation and Nature of Assets
- Equities as Sources of Capital
- The Nature of Owners' Equity
- Summary

### III. CLASSIFICATION BASES OF OWNERS' EQUITY ............ 46

- Statutory Classification
- Classification by Sources of Owners' Equity
- Classification of Owner's Equity by Investors
- Classification by the Restrictions on Owners' Equity
- Classification by Utilization of Owners' Equity
- Two-Stage Classification of Owners' Equity
- Effect of the Income Concept on Classification
- Summary

iii
IV. THE USES AND IMPORTANCE OF OWNERS' EQUITY TO THE READERS OF FINANCIAL STATEMENTS

The Users of Financial Statements
The Use of Owners' Equity in Financial Ratio Analysis
The Role of Owners' Equity in Predicting Dividends
Retained Earnings as an Indicator of Success
Appraisal Capital in the Analysis of Financial Statements
Provisions on Owners' Equity for the Protection of Creditors and Preferred Stockholders
Implication for Classifying Owners' Equity
Summary

V. EVALUATION OF THE CLASSIFICATION BASES FOR REPORTING OWNERS' EQUITY ON THE BALANCE SHEET

Source Method of Classification
Classification of Owners' Equity by Classes of Stock
Utilization Basis of Classification
Legal Basis of Classification
Classification by Restrictions on Owners' Equity
Comparative Analysis of the Classification Methods
Summary

VI. SUMMARY

Problem and Purpose of the Study
Statement Readers' Needs and Owners' Equity
The Nature of Owners' Equity
Classification Bases of Owners' Equity
Evaluation and Conclusions

BIBLIOGRAPHY
APPENDICES
VITA
LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. The Effect of Debt Agreements on Restricted Owners' Equity of Selected Corporations</td>
<td>167</td>
</tr>
<tr>
<td>II. Number of Times Dividends are Covered by Unrestricted Owners' Equity in Selected Corporations</td>
<td>168</td>
</tr>
</tbody>
</table>
ABSTRACT

At the present time, the owners' equity section of the balance sheet is not classified consistently in accordance with any one principle or set of principles. The lack of a principle or set of principles may result in misleading interpretations about the owners' equity by financial statement readers. The lack of a clear principle also fails to provide a framework within which accounting problems involving owners' equity can be solved.

The purpose of the study is to examine several principles that could be used in the classification of owners' equity and to evaluate their appropriateness and usefulness for financial reporting. The division of owners' equity by its sources, legal components, restrictions, classes of stock, and utilization are the classification principles that were examined in this study.

The value of classification lies in the utility of the information to its users. Therefore, the usefulness of the information to financial statement readers was used as the primary criterion in evaluating the principles for classifying the owners' equity section. A survey of financial analysis literature indicated that statement readers have need primarily for information concerning
the amount of the equity of each class of stock and the amount of capital that could be distributed to the stockholders. Outside of this data, statement readers have little use for additional information about owners' equity.

The classification into invested and retained capital has been frequently advocated by accounting writers in the past. However, the sources of capital are of little value to financial statement readers and may even be misleading.

Division by classes of stock appears to be the best principle for classifying the owners' equity section on the balance sheet. The equity assigned to preferred stocks should be based upon the capital contributed by each class of preferred stockholders. The residual equity should be assigned to the common stockholders. This method furnishes information that is useful to statement readers in computing the rate of return on each class of stock and for studying the capital structure of the firm. This classification method is also consistent with the concept that the equity side of the balance sheet represents sources of the firm's capital.

Restrictions on owners' equity may sometimes be significant information and should be reported. Restrictions refer to all legal and contractual limitations on distributions of capital to stockholders. If there is
only one class of stock outstanding, the owners' equity section could be classified upon the basis of restrictions. However, when there is more than one class of stock, the restrictions should be reported in the footnotes.
CHAPTER I

INTRODUCTION

The owners' equity section of the balance sheet reports the financial interests of the owners in a business enterprise. As is true for other aspects of financial reporting, the owners' equity should be presented fairly and in such a way as not to be misleading to the statement readers. One important aspect of a clear presentation is the arrangement of the information into parts which are both meaningful and correctly measured. However, relatively little critical investigation of the classification of the owners' equity section has ever been done in the past. The intent of this study is to explore the classification of the owners' equity section.

Problem of the Study

The Absence of a Classification Objective in the Owners' Equity Section

There are numerous bases or objectives which may be used in classifying the owners' equity section. One classification basis emphasizes the legal aspects of capital. Another method of classification emphasizes the sources of capital. Some bases concentrate upon the interest of the
various equityholders; other bases focus upon the amounts which are legally available as a basis for dividends.¹

Current statement presentation does not seem to conform to any of these bases. A firm's legal capital is rarely, if ever, pointed out in the balance sheet. Sources of owners' equity are frequently obscured by transfers between retained earnings and contributed capital. The equity of preferred stockholders is sometimes stated at amounts which are not representative of the preferred stockholders' interest. And unrestricted retained earnings, which is usually implied on the balance sheet as the basis on which dividends are declared, is not usually the basis which is specified under state corporate statutes for paying dividends. These disparities between objectives and the actual reporting of owners' equity have been pointed out by numerous writers in the accounting literature.² One easily concludes that the present manner of classifying the owners' equity section seems to be a mixture of several objectives, and consequently, none of the objectives is reported


adequately.

The Need for a Definite Classification Objective

To prevent misconceptions of statement readers.--
There are several undesirable results of an indefinite basis for classification. One is that the nature of some of the owners' equity classifications is too easily misinterpreted by financial statement readers. For example, many readers erroneously presume that retained earnings represent the cumulative amount of past earnings which have never been distributed to the shareholders. The statement readers overlook the fact that retained earnings can be transferred into legal capital and capital surplus.\(^3\)

Statement readers may also think that the balance sheet shows the legal aspects of capital and the amount available as a basis for dividends; after all, accounting textbooks usually do mention the legal issues when describing the accounting for corporations. But the owners' equity section does not disclose the legal aspects of capital very well. For example, one rarely sees any balance sheets which specify the amount of legal capital of the firm. Although par value is generally the legal capital of the firm, there are exceptions. Some states allow corporations to

\(^3\)Lowe, op. cit., p. 427.
set their legal capital above par value if the corporation's board of directors wishes to do so. On the other hand, Virginia allows legal capital to be less than the par value if the consideration received for the stock is less than par. In commenting upon the Virginia statute, one writer points out that creditors should not rely upon par value to infer the legal capital of the firm.

To provide a guide in accounting for owners' equity. A second major undesirable result is that the lack of any clear-cut objective may account for some of the controversies about allocating owners' equity among its different elements. As long as no classification objective is established, the elements of the owners' equity section cannot be defined in such a way as to be consistent with one another; nor can the dollar amount to be assigned to each element be determined very well. But if some classification basis were accepted, the solution to some accounting problems involving owners' equity should become more evident. Accounting for stock dividends is one case in point. The amount to be capitalized, if any, would be clearer if

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4 Michigan Statutes Annotated, Chapter 195, Section 21.70.


it were decided that the classification objective of owners' equity is to present either legal aspects of capital, sources of capital, restrictions on dividends, or some other objective.

A basic hypothesis of this study is that a classification basis is needed for the accounting of owners' equity and its components. Such a classification basis or objective could provide a guide which could be useful in arriving at solutions for valuing each element of owners' equity when certain accounting problems arise. A generally accepted classification objective would also be useful to financial statement readers because they would then be more aware of what the owners' equity signifies; readers might then be less apt to misinterpret parts of the owners' equity section.

**Purpose and Scope of the Study**

This study critically examines some of the various bases of classifying owners' equity. For each basis, the method of classification and its major components are described, the capability of measuring each component is discussed, and the usefulness of the classification bases to the statement readers is evaluated. The purpose of the examination is to determine which methods of classification are appropriate for financial reporting purposes.

This study is concerned primarily with the principles
in classifying and allocating owners' equity among its various elements. There are other important problems in accounting for owners' equity, too, but they are not taken up in this study. Some of the omitted problems are the accounting for the conversion feature of convertible stock; the valuation of owners' equity following purchases and poolings of interests; and the correct determination of net income and, thus, retained earnings. These issues have no direct bearing upon the classification of owners' equity, but they do have an indirect effect. The forementioned issues and problems affect the size of owners' equity. Obviously, if the size of owners' equity is incorrect, some of the components of owners' equity are misstated. However, determining the correct size of owners' equity is outside the scope of this study. This study focuses primarily upon the principles for classifying owners' equity.

The study is primarily a theoretical one. Although references are occasionally made to how owners' equity has been presented by several companies, the study is not a statistical investigation to ascertain what the common or usual practices are in corporate reportings of owners' equity.

The study is made within the framework of generally accepted accounting principles. The cost basis of accounting, the realization of revenue, the matching of revenues and costs, and other conventional accounting principles are observed.
Theory of Classification

Need for Classification

Man classifies knowledge because it is the only way he can use it in a manageable way. People are confronted with and acquire many varied pieces of information, impressions, and experiences. The knowledge one has is so vast that he is unable to comprehend all the individual events at any one time. This limitation hinders his ability to evaluate the data and make intelligent decisions. In order to organize the vast amount of knowledge into manageable proportions, man classifies the data into groups.

Classification Groupings

Most objects and events have numerous properties which describe the object or event. Objects have size, color, substance, or weight. In the act of classification, one particular property is chosen and is abstracted to the exclusion of all other properties. For instance, if objects are being classified according to their color, the weight, size, use, and value of the objects are disregarded. Each object and event can be classified according to each of its properties. Because objects and events have numerous properties, there are several possible ways of

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classifying an item.

Because there are many bases for classification, it leads to the question of whether there are any proper or natural classification bases. In other words, are there certain classification bases which are inherently correct and others which are not? Some might say, for instance, that the classification of animals into divisions of vertebbrata, mollusca, articulata, and radiata is a natural basis for classification while the classification of animals by color is not a natural classification basis.\(^8\)

The philosophers Cohen and Nagel do not think there is such a thing as natural classification, but neither do they think that all possible classification bases are equally useful or logical. To them, the most important criterion is to determine which trait or property is most significant and then use that trait as a basis for classification.\(^9\)

Classification is a mental activity which serves as a short cut to thinking. Any classification basis which helps a person to accomplish his purpose is useful and correct in that situation. However, the same classification basis which is useful to a person in one set of


\(^9\)Ibid.
circumstances may not be useful to him in a different situation. 10

Guidelines for Classification

Although there are not any natural classifications, there are some established guidelines to be used in classification. 11

Exhaustive groupings. -- The divisions into which items are being classified must be exhaustive. This means that there must be some division into which items of data can be classed. Practically speaking, divisions such as "miscellaneous" or "other" are used to catch those items which are insignificant and do not fall into any of the specific divisions.

No overlapping. -- The divisions should not overlap. Each division must exclude properties of other divisions so as to prevent an item from simultaneously fitting into two different divisions. For instance, the divisions of red, green, and other than red are not a proper classification arrangement. Green falls into two of the categories.

10 Chambers, loc. cit.

One classification principle per division.--Only one principle of classification should be used at any level. More than one classification principle at a level can also result in overlapping divisions. However, different classification principles can be used at different levels. As an example, one level could classify by colors, and each of the color divisions could be subdivided on the principle of economic value into expensive and inexpensive.

Definition of the divisions.--It is necessary in classification that the divisions be precisely defined. If the divisions are not well defined, there may be questions as to how some items should be classed.

Application to Owners' Equity

Two important principles about the classification of owners' equity can be drawn from the preceding discussion. One, the classification of owners' equity should conform to the guidelines which were presented. At any given level, only one principle of classification should be employed. Each classification basis should be exhaustive and also should be devoid of any overlapping. Each class should also be precisely defined.

Second, there is probably not any classification arrangement which is innately correct. Instead, there are numerous ways in which owners' equity can be classified. However, all the possible classification bases are not
equally valuable. For financial reporting, the important requisite is that the classification arrangement should provide information which is needed by the statement reader in making decisions. Usefulness of the information is the criterion by which the classification of owners' equity must ultimately be judged.

**Organization of the Study**

Chapter II sets forth a backdrop for observing owners' equity and its classification. The chapter deals with the nature of assets, liabilities, and owners' equity and attempts to define a meaningful relationship between the three balance sheet components. The major purpose is to lend some perspective to the study as a whole; after all, studying the classification of owners' equity is a futile exercise if the balance sheet has no real importance or significance.

The major ways of classifying owners' equity are taken up in Chapter III. For each classification basis, the components of owners' equity are enumerated and defined. Problems in valuing the components are also examined.

In Chapter IV, a review is made of the information that financial statement readers need about owners' equity in making their decisions. A major premise in the study is that the owners' equity section should convey information that is relevant to the statement readers. To judge the
usefulness of a classification basis, the uses which the
statement readers make of owners' equity must be known.

The various classification bases are evaluated in
Chapter V, and recommendations are made for classifying the
owners' equity section on the balance sheet.

Chapter VI is a summary of the major findings and
conclusions of the study.
CHAPTER II

THE NATURE OF THE BALANCE SHEET
AND OWNERS' EQUITY

In order to have a perspective for studying the classification of the owners' equity section, it is helpful to have an understanding of the nature of owners' equity. Such a perspective is provided in this chapter.

Owners' equity cannot be studied in a vacuum, for owners' equity is a component of the balance sheet. Because the nature of owners' equity should be studied within the context of its larger whole, it becomes necessary to think about the nature of the balance sheet and the relationship of all its components. Therefore, this chapter devotes a considerable amount of attention to the balance sheet, and in doing so, the nature of owners' equity emerges. Specific topics discussed are the equity theories, the cost valuation basis for assets, and the nature of equities.

This chapter is descriptive rather than prescriptive. As was mentioned in the introductory chapter, this study is being made within the framework of accounting principles which are now generally accepted by the business and accounting community. Therefore, this chapter attempts to
explain the significance of owners' equity and the balance sheet as they are now presented in financial statements. This chapter attempts to explain "what is" rather than "what should be."

The nature of the balance sheet and owners' equity as presented in this chapter is not the only interpretation which accountants have developed. At the present time, there is no unanimous agreement among accountants as to what the balance sheet is or what it should do. Nevertheless, to study a segment of the balance sheet requires that some basic assumptions be made about it. No presumption is made that the philosophy presented here is the only valid one, but it is a satisfactory explanation of the balance sheet as it exists today.

The Multiplicity of Balance Sheet Concepts

The balance sheet is one of the two most common financial statements that is produced. Its existence in some form or other dates back for several centuries.¹ But despite its long existence, its prominence as a major financial statement, and its well-known mechanics of preparation, the nature of the balance sheet is still not precise nor recognized.

The Terminology Bulletins of the American Institute of Certified Public Accountants define a balance sheet as a tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books of account kept according to principles of accounting.2 This authoritative definition tells something about the mechanics of the balance sheet. However, the definition tells very little about the nature of the balance sheet.

In the 1960's, numerous articles were written about the nature of the balance sheet. The writers had rather diverse opinions which tended to exemplify the unsettled state of the balance sheet. For instance, Marple argued that the balance sheet does not tell about the financial position of the firm. Instead, he contended that the balance sheet is a report about the firm's capital.3 Ashburne felt that the low esteem of the balance sheet is caused by misconceptions people have of the statement. Ashburne suggested that the balance sheet should emphasize the future recoverability of past costs.4 Battista and Crowingshield

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wrote that the balance sheet is so unserviceable that it should be omitted from the annual reports. Zeff vehemently disagreed with the suggestion of Battista and Crowning-shield. Chambers maintained that the present cost basis of the balance sheet does not provide the information upon which people must make financial decisions. Moonitz and Sprouse advocated the use of current values on the balance sheet. Others recommended using price-level adjustments. Other accountants still maintained that the cost basis is most desirable.

In the following sections, some of the balance sheet concepts which provide an insight into the nature of the owners' equity section are studied.

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Equity Theories

In accounting for the business enterprise, there are several viewpoints from which the financial data can be reported. These viewpoints are known as equity theories. The equity theories provide a framework in which the nature and the classification of owners' equity can be studied. Four equity theories are discussed in this section with special emphasis on their significance to the balance sheet.

Proprietary Theory

The oldest of the equity theories is the proprietary theory. As its name implies, the theory emphasizes the role of the proprietor. Under this theory, accounting for the business is done from the viewpoint of the proprietor. The assets are considered to be his property; the liabilities, his debts. Any excess of the assets over the liabilities represents the net worth of the owner. Of course, any changes in the amount of assets over liabilities represent corresponding changes in the net worth of the owner. In essence, the business and its owner are one and the same. What affects the business affects the owner as well. When accounting for the business, the owner's wealth in the business is being accounted for at the same time.

The proprietary theory seems to be quite appropriate for business enterprises which have only one owner. But the proprietary theory cannot be adapted to the
corporate form of business very well. One of the reasons for this inadequacy is the high turnover and manner in which ownership changes take place. Upon coming into existence, the corporation issues shares of ownership and directly receives the proceeds from their sale. After the initial issuance of the shares, the corporation seldom buys or sells its own stock. Instead, most transfers of corporate ownership are the result of transactions between stockholders. The sales price of transactions between stockholders can be any figure upon which the parties agree. It is probably very seldom that the sales price is the same as the book value of the stock on the books of the corporation, and this is where the problem arises.

The corporation does not record the prices of the stock exchange transactions in its financial records. It is at this point that the corporation's report of owners' equity is no longer equal to the shareholders' cost or investment to acquire ownership in the firm. Consequently, the corporation's accounting records do not represent the stockholders' investment in the same way as in a one-owner business. Nor does the reported corporate income represent a proper basis for computing the individual stockholder's personal profit or gain. In computing the

corporate profit, expenses are based upon the recorded book value for assets of the corporation. The expenses do not reflect the investment costs of the shareholders. As a result, the corporation's computation of profits is not necessarily the same as the stockholders' profits. Nor is the profit per share of one stockholder necessarily the same as for another stockholder. Even if the corporation tried to update its owners' equities to reflect what was paid by each stockholder for his shares, the continual corresponding revaluation of assets would make the computation of expenses quite difficult.

Entity Theory

The weaknesses of the proprietary theory in accounting for corporations led to the development of the entity theory. The entity theory's distinctive characteristic is that it accounts for the business firm and its operations from the viewpoint of the business and not from the viewpoint of its owners. The business is regarded as being separate and distinct from its stockholders. In this respect, the entity theory resembles the concept of the corporation as it is established by legal statutes. Some accountants cite the legal concept to justify the accounting entity concept. However, the inability of the

proprietary viewpoint to account for stock transfers would seem to be a better justification of the entity theory. In fact, the entity concept can be applied to any business enterprise whether or not it is a corporation.

From the entity viewpoint, the business enterprise is entrusted with a group of resources. The resources are entrusted to the firm by various groups of persons, and these persons are said to have an equity in the firm. Since all resources have been contributed by someone, the equities in the firm are equal to the total assets. The equities of the firm include both the creditors and the stockholders. Both of these groups are considered to be similar in nature. As far as the entity is concerned, both are suppliers of the firm's capital, and in a sense, even the owners' equity can be considered to be a liability.

From the entity point of view, the center of attention is on the pool of resources and the equities in that pool. Only those transactions which affect the resources and its corresponding equities are even recorded. Thus, if a stockholder buys shares of stock directly from a corporation, the resources of the corporation are increased and so is the recorded owners' equity. However, if the stockholder

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purchases his stock from another stockholder, the corporation's resources are not affected; nor is the recorded owners' equity changed in any way. Thus, under the entity concept, owners' equity represents the amount of resources which the business has received directly from its owners plus any retained earnings. Owners' equity is not the amount which the present stockholders may have paid to acquire an ownership in the firm. To reiterate, the entity theory reports from the viewpoint of the entity, not of the proprietors.

**Fund Theory**

William J. Vatter contended that both the proprietary and entity theories are unsatisfactory, and he originated the fund theory as a viewpoint for accounting. Vatter felt that the proprietary and entity theories are unsatisfactory because they are based upon the personalization of the firm. In one case, the business enterprise is viewed as having the personality of the proprietor. In the other, the entity is institutionalized and is given a personality of its own, separate and distinct from its owners, creditors, and managers. Vatter warns that

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the weakness in these personalized bases for accounting is that the content of accounting reports will tend to be affected by personal analogies; and issues will be decided not by considering the nature of the problems but upon some extension of personality. . . . Dependence upon personality and personal implications in accounting theory, even as a convention, does not contribute to that objectivity toward which all quantitative analysis is aimed.15

Vatter also points out that accounting reports are used by many groups: management, creditors, investors, and regulatory agencies. The uses of accounting information by these groups are diverse, and no single personality of the business enterprise can effectively serve all the different points of view. Vatter concludes that a more objective or fundamental approach to accounting theory is needed in place of the proprietary and entity viewpoints. Vatter offers the fund theory.

Vatter's fund theory, which is an extension of the entity theory, de-emphasizes the personalization of the entity. Under the fund theory, a fund is any group of assets which have been set aside for a specific function or to describe a set of activities. The fund could be, for example, a business, a governmental agency, working capital, or a branch of a business.

Each fund also includes equities. However, in the fund theory, equities are not considered to represent ownership or claims against the assets. Instead, "equities are

viewed as restrictions that apply to assets in the fund, which therefore condition the operations of the fund as dictated by the management."¹⁶ For example, liabilities represent a restriction which requires that assets be available so that debts can be paid when due. Capital stock is a restriction on the fund which requires that original capital be maintained. Appropriations of retained earnings represent restrictions imposed upon the use of assets. And although unappropriated retained earnings does not impose any specific restrictions on the fund, unappropriated retained earnings is restricted in the sense that all the fund's assets are devoted to the operation of the fund.

Under fund theory, financial reports would not be highly structured as they are now. The balance sheet could be arranged and valued in various ways depending upon the uses to be made of the statement. For instance, a balance sheet for credit purposes would value assets in such a way and arrange the data in a form that would emphasize the ready availability of assets for liquidation of indebtedness. Investors would be interested in at least two kinds of balance sheets. One would be a "charge and discharge" statement of stewardship. A second kind of balance sheet is one which presents information relevant to the firm's

¹⁶Ibid., p. 19.
future. According to Vatter, the important thing is that the financial statements be designed with some purpose in mind and that a valuation basis be used which would best accomplish the purpose of the report.

According to Vatter, the value of the fund theory is that the notion of a fund is not encumbered with personalistic thinking. The fund concept would provide a fresh, objective outlook in thinking about financial accounting.

**Residual Equity Theory**

Another equity concept is the residual theory developed by Staubus. In this theory, all equityholders are divided into two groups: the specific equityholders and residual equityholders. The specific equityholders are the creditors and the preferred stockholders; their interest in the enterprise is a definite amount in accordance with a contractual agreement. The residual equityholders are those who are entitled to any residue of the enterprise's operations. In normal business situations, the common stockholders are the residual equityholders.

Specific equityholders are vitally interested in knowing how well the firm will be able to pay its claims as

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they come due. Residual equityholders are vitally interested in knowing how much the enterprise will be able to pay as dividends in the future. Therefore, each creditor and investor hopes that the present cash balance plus future cash receipts less future cash disbursements will leave a future cash balance that is large enough to pay his claim on the due date or pay a dividend at the time as expected. All equityholders desire information related to the future course of the firm's cash position, and Staubus suggests that the balance sheet should provide data along this line. He advocates that assets should symbolize cash receipts which are quite certain to be collected in the future. Equities should be thought of as future cash disbursements.

Staubus considers the residual equity to be very important because all equityholders are interested in its amount or size. To the specific equityholders, residual equity serves as a buffer. Because future cash flows cannot be accurately predicted, a margin of safety is desired by the creditors. Any increases in the residual equity, whether contributed by the common stockholders or as a result of profitable operations, enhance the position of the specific equityholders whereas decreases are unfavorable. The amount of the residual equity is also of importance to the residual equityholders since it is a measure of their claims. Because all equityholders have a strong interest in the residual equity, Staubus recommends using the
residual equity as a focal point in financial accounting rather than adhering to the proprietary or entity equity theories.

Under the residual theory, measurement of the residual equity is dependent upon the correct measurement of assets and specific equities. Since the future cash receipts and disbursements are of primary concern to all equityholders, assets and equities should be measured in terms of their expected cash flows. However, it is difficult to predict the future cash flows of assets very precisely, so alternative measurement techniques often must be used. As a result, valuation bases such as net realizable value, replacement costs, discounted cash amounts, and adjusted historical costs are used in valuing assets and equities under the residual equity concept.

Evaluation of the Several Equity Concepts

The salient points of several equity theories have been presented. These theories must be evaluated to ascertain which of them might offer the best explanation of the nature of the balance sheet as it is prepared today.

One of the major functions of the residual equity theory is to measure the margin of safety of the specific equityholders on the date of the balance sheet. In order to measure the margin of safety, the assets must be valued at up-to-date values. But present-day accounting assigns
values according to the costs of the assets. Past costs tend to become out-of-date, and consequently, do not reflect the present margin of safety of the specific equity-holders. Since the cost basis is not compatible for measuring the residual equity nor for indicating future cash receipts, the residual equity theory does not offer a relevant explanation concerning the nature of the conventional balance sheet which is prepared on the cost basis.

The fund theory also fails to provide an explanation about the conventional balance sheet. As was noted earlier in the discussion on fund theory, new financial reports would be devised to meet the specific needs of the reader of the report. As Goldberg has written, the fund theory tends to advocate new ways of reporting financial information rather than to furnish an explanation of present financial reports and records. Goldberg also contends that the fund concept does not provide a sufficient foundation on which to base accounting theory.\footnote{Louis Goldberg, An Inquiry into the Nature of Accounting (Iowa City, Iowa: American Accounting Association, 1965), pp. 149-51.}

A notable feature of the proprietary theory is that it stresses the role of the owner. It is for the owner's benefit that the firm is operated, and it is the owner who usually has the most concern of any group for the enterprise and its success. The proprietary point of view can
be easily implemented in sole proprietorships and in those multi-owner businesses which have infrequent changes of ownership. But as was demonstrated earlier, the proprietary theory is impractical to use in accounting for businesses in which transfers of ownership take place frequently.

The entity concept offers an equity theory which is applicable to corporations as well as to simpler forms of business organizations. Although many accounting writers stress the legal separation of the corporation from its stockholders as a justification of the entity theory, its superiority lies in that it is a satisfactory method for handling frequent changes in ownership. The entity concept can also be used in accounting for proprietorships and partnerships as well as for corporations.

However, there are criticisms of the entity theory. Critics of the theory think that too much emphasis is placed on the entity and that too little consideration is given to the investors in the entity. As one writer has pointed out, the corporation is not operated for its own benefit, but instead, is operated for the benefit of its investors. The corporation is only a legal device which makes it easier for a large number of individuals to pool their resources into profitable undertakings. Regardless of the legal characteristics, the corporation is basically an organization of individuals. For these reasons, George Husband thinks that financial reporting should stress an
agency or entrepreneurial point of view rather than the entity viewpoint.\(^{19}\) And in the opinion of Goldberg, the problems caused by transferability of ownership are the only justification for the entity concept in accounting; other than this, the proprietary point of view would be proper.\(^{20}\)

The Equity Theories in Current Use

In the accounting practice of today, the entity theory is supposedly the dominant one.\(^{21}\) For instance, the manner in which corporations account for transfers of ownership is in accordance with the entity theory. Many balance sheets also express the entity viewpoint by presenting the statement in the format of assets equal liabilities and owners' equity.\(^{22}\) In 1967, the assets-equal-liabilities-and-owners'-equity style was used by 556 of the 600 companies surveyed in Accounting Trends and Techniques.\(^{23}\)

Another feature which characterizes the entity theory is found in some balance sheets which entitle the


\[^{22}\] Hendriksen, Accounting Theory, p. 396.

right-hand side as "liabilities and stockholders' equity."
The right side lists the current liabilities, long-term debt, deferred credits, minority interests in subsidiaries, and stockholders' equity. However, there is not any explicit division of these items into liabilities or owners' equity. Nor is any figure designated as total liabilities. Consequently, the impression is that all the items on the right side are very similar in nature. Maybe all the items are equities as is suggested in the entity theory. Some very clear illustrations of this are found in the 1968 balance sheets of Armstrong Cork Company, Ashland Oil & Refining Company, and Bethlehem Steel Corporation.24

Some companies go even further and use only the term "liabilities" as the title of the entire right side of the balance sheet. This title is clearly in accordance with the notion of the entity concept. The 1968 annual reports of Boise Cascade Corporation; Borden, Inc.; and J. C. Penney Company are examples of this.25

There are some prevalent accounting practices which are not consistent with the entity theory, but instead, are in accordance with the proprietary point of view. Under


entity theory, interest charges and income taxes are a distribution of income rather than a deduction in computing income.\textsuperscript{26} In practice, however, both interest and income taxes are treated as expenses, and income is the residue of revenues from the proprietor's point of view.

A closely related issue is to whom the retained earnings belong. Under the proprietary theory, income of the business is also income to the proprietors, and hence, the retained earnings are part of the owners' equity. But the status of retained earnings in the entity concept is not so clear. Under the entity concept, income of the business is not considered to be income to the owners until there is a severance of assets by the entity to the owners. Thus, George Husband says it would be inconsistent under the entity theory to think of retained earnings as a part of the owners' equity; instead, he maintains that the retained earnings are an equity of the entity in itself.\textsuperscript{27} But Paton and Littleton contend that under the entity concept, retained earnings is a part of owners' equity. Their reasoning is that even though the owners do not yet have an income, the owners do have a claim against the undistributed earnings of the entity. It is this claim, not the income, which is the justification for retained earnings being

\textsuperscript{26}Paton, Accounting Theory, pp. 264-71.

\textsuperscript{27}Husband, "The Entity Concept in Accounting," pp. 554-58.
considered as part of the owners' equity. Regardless of the theoretical issues, retained earnings is generally considered to be a component of owners' equity in current financial reporting.

None of the equity theories has gained anywhere near a unanimous acceptance. Each of the theories emphasizes a different aspect of the enterprise, but each of the theories is also incomplete in that none of them can fully account for all the important characteristics or situations of the business enterprise. Some accounting authorities recognize the shortcomings of each concept and insist that the most important thing is to use in a consistent manner the equity theory which is chosen. On the other hand, maybe the "true" equity theory has not yet been conceived, and until that time, shifts of equity viewpoints within financial statements might be excusable to overcome some of the obvious deficiencies of any one equity concept.

The Valuation and Nature of Assets

Valuation of Assets

Cost basis.--One of the most fundamental concepts of present-day accounting is that the valuation of assets be based upon their cost. The merit of the cost basis is its

\[\text{\textsuperscript{28}}\text{W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (Columbus, O.: American Accounting Association, 1940), p. 8.}\]

\[\text{\textsuperscript{29}}\text{Hendriksen, Accounting Theory, p. 403.}\]
objectivity. The price in a transaction is usually quite evident and is easily verified. By using historical costs, the accountant's own personal bias and subjective judgment are kept to a minimum in the accounting records.

The cost basis represents the value of the asset or service at the time of the exchange transaction. The price paid is established by arm's length negotiations of two separate parties who are each attempting to maximize their own financial position. But as time passes, the value of the asset might change, and as a result, the original exchange price no longer represents the current exchange value. On the accounting records, however, the asset continues to be shown at cost.

Current valuations.--The disparity between the original cost and the current value of assets has been quite disturbing to many persons. Many accounting theorists believe that the balance sheet would be more useful if the assets were reported at up-to-date values. A frequently mentioned reason for using current values is that an asset represents a future economic benefit. Therefore, some persons contend that the dollar amount to be identified with the assets should be the expected benefits flowing from the assets. For example, marketable securities would be valued at the amount they could be sold for, and inventories would
be valued at their net realizable value. In lieu of expected future receipts, a substitute basis such as current market value is sometimes suggested. As the American Accounting Association's Committee on Concepts and Standards--Long-Lived Assets maintains:

a practical approximate measurement of service potential may be attained by reference to the current cost of securing the same or equivalent services.

There are some weaknesses in reporting assets at their current market or replacement values, especially when the value identified with the asset is considered to approximate its future service potential. Some writers contend that assets should be valued in relationship to the specific enterprise. The value of an asset should be the amount the enterprise will realize from the asset in its planned use by the firm, not the amount for which others are buying the same asset. To illustrate, two business firms may own an identical piece of machinery. If one firm uses its machine more effectively than the other firm, the economic benefits of the machine are different to each firm. The current

30 Sprouse and Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises, pp. 24-30, 57.


market values, which would be identical for both firms, would not reflect the differences in future economic benefits. As many writers acknowledge, there are intangible factors which have some impact upon the real value of the assets. It would seem that the current market value is only a partial explanation of the assets' value to the firm.

Some may think that a balance sheet prepared on the basis of current values for the assets reflects the value of the business enterprise as a whole. However, the value of a firm depends upon its future earnings. In general, using the aggregate current values of a firm's assets to represent the value of the business as a whole is subject to the same weaknesses as using the current market value of an individual asset to represent its future economic benefits. The firm has intangible factors which will affect its profits.

**Nature of the Assets**

Because this study of owners' equity is being made within the framework of generally accepted accounting principles, the nature of assets must be defined in a way so as to be consistent with the cost basis.

Assets are defined as a pool of resources which the business has at its disposal. Although assets are recorded as dollar amounts, assets are more than dollars. Assets are very real things such as machinery, inventory, and cash,
which are useful in carrying out the firm's operations. Assets are the resources which management has available for use.\textsuperscript{33}

The dollar amount shown for an asset is the cost of that resource. The cost merely indicates how much of the firm's capital has been invested into a particular asset or group of assets. To read any additional meaning into the figures is erroneous. As was discussed earlier, cost is not likely to be equal to either the replacement cost or the current sales value of the assets. Nor does cost represent the amount of future benefits to be derived from the use of the assets.

In summary, assets only show the firm's resources and the amount of capital originally invested in each resource. In no way can the list of assets and their costs indicate how well management will use the resources. The list of assets only provides a starting point for persons who are analyzing the business. With the help of this list and other information about the firm, the investor must make his own valuation of the firm and its future operations.

Equities as Sources of Capital

As was mentioned earlier, the entity concept is probably the best accepted of the equity theories. Most balance sheets are also presented in the form which typifies the entity point of view. Therefore, in discussing the nature of the balance sheet as it is presented today, its entire right-hand side will be thought of as representing the equities of the firm.

An equity is usually defined as a claim or right. However, this definition does not tell very much about the nature of a claim or right. Additional consideration must be given to the meaning of equities.

Definition of Capital

Before continuing, the term capital should be defined as it is used in the remainder of this chapter. Capital refers to the total assets of a business. Littleton defines capital as "the sum total of property active in the business from whatever source derived." Paton defines capital as "a mass of commodities and services but in a sense independent of the variations in the character and identity of the concrete units making up

the mass." It is in this collective sense that capital is used in discussing the equities.

Liabilities and Owners' Equity as Sources of Capital

Because a business is considered to be an artificial entity, the business firm by its nature does not have any resources or capital of its own. Any capital which the firm possesses is lent to it, and in return, the lenders have an equity in the enterprise. Conversely, anyone who holds an equity in an enterprise is lending or supplying capital. For example, stockholders have an equity because they provide capital either by investing directly into the firm or by allowing the profits to remain in the business rather than withdrawing assets. Trade creditors have an equity because they have supplied assets which have not yet been paid for by the firm. The government may also have an equity in the firm because by allowing firms to postpone or defer their payments for income taxes, the government is providing firms with capital which the firms would not have otherwise. Employees who are awaiting compensation for

35 Paton, Accounting Theory, pp. 91-92.

past services also have an equity in the firm; these employees are providing capital which the firm would not have if the wages had been paid immediately when earned. As the examples illustrate, equities represent the sources of a business enterprise's capital.

Paton and Littleton discuss whether equities should be based upon the source or the recipient of capital (the amounts contributed or the amounts to be paid). They illustrate the point with a bond which has been issued at a premium. The bondholder's equity on the books of the issuer is the amount of the total proceeds, not the maturity amount. Paton and Littleton conclude that:

the funds invested in a corporation should be credited to the liability and stock accounts in accordance with the actual amount contributed by each group of investors; that is to say, the distribution amount which might be required in the event of reorganization, liquidation, or other special settlement is not the effective figure from the point of view of the going concern. The equity accounts are of course subject to modification through the process of assigning income or loss, and in the event of continued loss of senior securities may be maintained at the expense of the residual equities. Whatever the changes required by subsequent conditions, only the amount invested can furnish a clear-cut starting point.

Paton and Dixon also express a similar viewpoint when they define assets and equities:

The assets are the economic resources of the enterprise and the equities represent the sources of the funds--

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38Paton and Littleton, An Introduction to Corporate Accounting Standards, pp. 42-43.
and the legal rights—reflected in the total assets. 39

Harold Bierman writes:

The term equities refers to the rights of the various contributors of assets to the firm. The amount of the equity of each group is equal to the dollar amount of assets they contribute to the firm. 40

On the balance sheet, Bierman prefers the phrase "sources of assets" in place of the term "equities" to describe the right-hand side. 41 He also points out that the asset sources do describe the firm's obligations to each class of the capital suppliers. 42

Criticism of Equities as Sources of Capital

The notion that the right-hand side of the balance sheet represents sources of assets has drawn criticism. Robert Sprouse contends that dividends payable, interest payable, and taxes payable do not represent sources of assets except in the perverted sense that they represent amounts that have not required the use of any assets; he writes that these payables represent obligations rather than sources of assets. Sprouse also contends that


41 Ibid. 42 Ibid., p. 76.
statement readers are more interested in the amounts and due dates of future obligations than in the sources of assets. In summary, Sprouse definitely feels that liabilities on the balance sheet should be thought of as future obligations rather than asset sources. In addition, he notes that the most meaningful report about the sources of assets is found in the funds statement rather than in the equities section of the balance sheet.  

The equities side of the balance sheet has been gradually changing. Equities used to be thought of as consisting only of owners' equity and amounts owed to creditors. However, items have been appearing in the right-hand side of the balance sheet which do not fit into either of these two categories. Examples are deferred investment credits, deferred income on sale and leaseback transactions, and reserves for estimated costs of discontinuing facilities. Some accountants deplore this trend and believe that the strict concept of liabilities should be followed. On the other hand, there are accountants who say that a more

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flexible approach needs to be taken with concern to liabilities and that the notion of equities being sources of capital should be accepted.\textsuperscript{45}

Conclusion

For this study, equities will be used to mean sources of capital. This definition is concordant with the two-sided view of the entity theory which describes the balance sheet as a pool of assets and their equities. The sources-of-capital concept is also broad enough to account for the deferred credits which are now used to produce a better measurement of periodic income.

The Nature of Owners' Equity

The nature of the balance sheet, assets, and equities has been discussed. From the past discussion, the nature of owners' equity can be extracted.

The owners' equity represents the dollar amount of assets that have been supplied to the firm by owners. From the entity's point of view, the owners are a source of capital just as are the trade creditors, employees, and bondholders. Of course, the owners do differ in many other respects from the creditors. However, the balance sheet is a report on the sources of a firm's capital, and for

\textsuperscript{45}Hawkins, op. cit., p. 38.
this reason, creditors and owners are treated as a homoge-

nous group on the balance sheet.

As has been stressed previously, the amount of the
owners' equity is reported from the entity's point of view,
not from the viewpoint of the stockholders or owners. The
owners' equity represents only the amount of capital that
was originally received by the entity upon the initial
issuance of the shares of stock plus any retained earnings
which have not yet been distributed. In those firms which
have had numerous transfers of ownership, only a part of
the owners' equity shown on the balance sheet was actually
supplied by the current or present stockholders. Instead,
most of the owners' equity was probably supplied to the
firm by previous stockholders through their original pur-
chase of stock directly from the firm plus their share of
undistributed earnings. The contribution of the present
stockholders to owners' equity is only their share of un-
distributed earnings which have arisen since the present
stockholders became owners of the firm. It can be a se-
rious error to construe the owners' equity as representing
the amounts which the present stockholders have paid in
order to acquire their ownership.

The aggregate market value of a firm's outstanding
stock is seldom the same as the owners' equity shown
on the balance sheet. The owners' equity represents the
dollar amount of assets contributed to the firm by owners
whereas the market value of the stock is dependent upon the future expected profits of the firm. Since two different valuation bases are used in determining owners' equity and the market value of the stock, the two will seldom be the same amount.

Summary

In this chapter, an interpretation of the conventional balance sheet has been presented. In summary, the balance sheet is a report on the enterprise's capital. The balance sheet indicates how much capital has been committed to the firm by various groups of persons and in what assets the capital is now held.

In searching for an explanation of the balance sheet, several of the equity theories were examined. Despite the shortcomings of all the equity concepts, the entity theory seems to offer the most insight as to the nature of the balance sheet. Under the entity theory, the balance sheet is a report about the firm rather than about its owners; it resembles a manager giving an account of the assets the firm holds and the equities in the firm. The superiority of the entity concept is that it provides a viewpoint which is compatible in accounting for frequent transfers of ownership.

The assets are facilities which the firm has at its disposal. The dollar amounts accompanying the assets
represent cost or the amount of the firm's capital which is invested in that asset. One should be careful about inferring any additional meaning into the figures shown on the balance sheet.

The equities are the sources of capital, the two major sources being the creditors and the owners. The owners' equity consists of capital which the firm has received directly from its past and present owners plus the retained earnings.

The balance sheet provides only a very limited type of information about the firm. Admittedly, the information provided may not be very illuminating and may not tell the reader what he would really like to know. The balance sheet does not report the current values of the assets nor the future value of the firm or its stock. Neither does the balance sheet tell about the intangible factors which may affect the firm nor indicate how well management will operate the firm in the future. The balance sheet only tells what facilities and resources the firm has, the cost of those resources, and where the firm acquired the capital that is invested in the resources.
CHAPTER III

CLASSIFICATION BASES OF OWNERS' EQUITY

There are numerous bases or objectives which may be used in classifying owners' equity. However, all of them may not be feasible or capable of implementation. In order for a classification basis to be practicable, its components must be identifiable and capable of being measured.

The purpose of this chapter is to study the feasibility of the various classification methods. Each major classification basis is described, and the problems and implications in the measurement of the components are explored.

The methods of classification to be discussed in this chapter are based upon:

1) the provisions of state corporate statutes,
2) the sources of owners' equity,
3) the equities of the various owners,
4) the restrictions on withdrawals, and
5) the utilization of the owners' equity.

In addition, two other related subjects to be discussed are the use of a two-stage method of classification and the effect of the income concept on classification.

Obviously, the above list of classification methods
is not exhaustive. There are other possibilities of classification, for a classification basis can be conceived for every kind of trait or characteristic of owners' equity. For example, some would be the year in which the equity was acquired, the destination of owners' equity, and the amount permanently committed. However, the classification methods discussed in this chapter are probably the most significant ones.

Statutory Classification

Purpose of the Statutory Classification

All states have laws which impose restrictions on the owners' capital of corporations. Under these statutes, owners' equity is segmentized into several parts, and different restrictions are put on each part. The division of owners' equity into segments as specified by corporate statutes is a basis which could be used for classifying owners' equity on the balance sheet.

The purpose of the legal restrictions on owners' equity is to protect the creditors of the corporation. Because of the limited liability feature, creditors need some assurance that the stockholders will not indiscriminately withdraw most of the assets from the corporation and thus jeopardize the firm's ability to pay its debts.¹

The philosophy originally adopted for corporate regulation was that the capital invested by stockholders was regarded as a permanent investment; the creditors could always rely upon this margin of safety being present (although it could be decreased by operating losses). The amount by which assets exceeded the total of liabilities and invested capital was surplus, which was derived from profits. Asset distributions to stockholders could not exceed the amount of surplus. Thus, the earliest division of owners' equity was into surplus and invested capital, or in terms of their restrictions, capital which could and could not be distributed to stockholders. However, abuses in the issuance of stock and the introduction of no-par stock brought about changes in defining components of owners' equity. Competition among states to attract industry also resulted in changes that diluted the traditional legal components of owners' equity.  

Legal Divisions of Owners' Equity

In the Model Business Corporation Act and in recently revised state statutes, there are three components of owners' equity: stated capital, capital surplus, and earned surplus. Briefly, stated capital is the amount

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3Model Business Corporation Act, Sec. 2.
which is legally committed on a permanent basis. Any excess of owners' equity over stated capital is surplus, the surplus being divided into earned surplus and capital surplus. Generally, earned surplus is the same as the accounting concept of retained earnings. Capital surplus is any surplus other than earned surplus.

However, some states still classify owners' equity into stated capital and surplus with no differentiation of the surplus into two parts.  

Stated Capital

Basic Elements.—Stated capital is a quantum representing that part of owners' equity which has been declared as permanent capital by the corporation's board of directors. Except in special circumstances, the firm cannot give any dividends which would lower the stockholders' interest in the firm below the amount of stated capital. The purpose of stated capital is to provide a buffer or margin of safety to creditors by putting a maximum limit upon how much of the firm's assets can be distributed to the stockholders.

As a minimum, stated capital must generally be equal to the par value of the issued stock. However, if the stock is without a par value, some amount of the

4Delaware Code, Title 8, Sec. 154; New Jersey Revised Statutes, Sec. 14:8-19.
consideration received for the stock must be designated as stated capital. In addition, some of the firm's surplus can also be designated as stated capital. There are numerous variations of stated capital among the states, and a few of the variations are noted.

The Ohio statutes specify that in the absence of any action by a corporation's board of directors, stated capital is the entire amount of consideration received when the consideration exceeds the par value. However, if the board of directors wishes to do so, it may specify that the consideration in excess of par be designated as capital surplus. In Virginia, stated capital is equal only to the amount of consideration received when stock is issued for less than par value.

When no-par value stock is issued, the entire consideration received is designated as stated capital unless the board of directors allocates some of the consideration to capital surplus. Some states limit the allocation to a maximum of twenty-five per cent of the consideration while other states do not impose any such restriction upon the amount that can be allocated to capital surplus. However,

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5 Model Business Corporation Act, Sec. 19.
6 Ohio Revised Code Annotated, Sec. 1701.30 (B) (1) (Supp. 1956).
if the no-par stock has a liquidation preference, the stated capital must be equal at least to the liquidation value of the stock; only the excess of consideration received over the liquidation amount may be assigned to capital surplus. In some states, the liquidation value refers to voluntary liquidation whereas in other states it refers to involuntary liquidation. 8

**Increases of stated capital.**--Stated capital can be increased by methods other than the sale of new shares of stock. For example, the par value per share can be increased and therefore automatically requires a transfer of surplus into stated capital. Stated capital can also be increased by a decision of the directors to transfer either capital surplus or earned surplus to stated capital. And whenever a corporation issues a stock dividend, statutes usually require a transfer of surplus to stated capital in an amount at least equal to the aggregate par value of the newly-issued stock. 9 (The transfer usually can be from either capital surplus or earned surplus.)

**Decreases of stated capital.**--Stated capital can be decreased in several ways. For instance, the New York


corporation law allows the board of directors to reduce stated capital by eliminating amounts which had previously been transferred to stated capital from surplus, by arbitrarily reducing the amount of stated capital of stock without a par value, and by canceling shares of the corporation's own stock. Approval by the stockholders to reduce the par value per share also decreases the stated capital of the firm. Several states also allow the stated capital to be reduced for a partial liquidation; this facilitates the distribution of a large part of a firm's assets when they are no longer needed.

The acquisition of treasury shares does not reduce stated capital. However, if the treasury stock is subsequently canceled, stated capital is then reduced.

Convertible stock and stated capital.--Stated capital is sometimes affected by conversions of preferred stock into common stock. One such instance is when the par or stated value of convertible preferred stock is less than that of the common stock for which it is exchanged. In this case, an adequate amount of surplus must be transferred

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12 Ibid., p. 253.
to stated capital. Sometimes, though, the par or stated value of the convertible stock is more than the par value of the new shares being issued. In this situation, some state corporation laws do not allow any reduction to be made in the stated capital.\footnote{Ibid., pp. 255-56.}

\textbf{Earned and Capital Surplus}

\textit{Definitions.}--Under the Model Business Corporation Act, earned surplus is defined as the summation of all past profits, gains, and losses less distributions of property to the stockholders and any amounts which have been transferred to either stated capital or capital surplus. Capital surplus is simply any part of surplus which is not earned surplus.\footnote{Model Business Corporation Act, Sec. 2.} In most cases, capital surplus consists of consideration received for the stock in excess of stated value and also of capital which has been transferred to it from stated capital or earned surplus.

Most states have adopted, for the most part, the definitions of earned and capital surplus as they are presented in the Model Act. However, Louisiana defines capital surplus in detail, and earned surplus is defined as any surplus which is not capital surplus. In Louisiana, capital surplus consists of consideration received in excess of
stated capital, amounts transferred to capital surplus from stated capital and earned surplus, and amounts resulting from the revaluation of assets, less any transfers to other components of owners' equity.  

Unrealized appreciation.--The Model Business Corporation Act is silent as to how unrealized appreciation should be classified. According to two members of the committee which drafted the Model Act, unrealized appreciation should be classified as part of earned surplus but made available only for stock dividends. However, some states which have used the Model Act as a guide in revising their corporation laws are more explicit in their treatment of unrealized appreciation. Texas and South Carolina expressly exclude unrealized appreciation from earned surplus. As was mentioned in the Louisiana statute, appraisal capital is clearly part of capital surplus.

Gains on the sale of treasury stock.--The Model Act is also unclear as to the classification of the proceeds from the resale of treasury stock which exceeds its cost.

15 Louisiana Business Corporation Law (1968), Sec. 1.


17 Texas Business Corporation Act (1955), Art. 1.02 (13); South Carolina Business Corporation Act, Sec. 1.2 (q).
Some legal experts argue that the sale of treasury stock for more than its cost represents a gain and, by definition, is part of earned surplus. Others accept the accountants' interpretation that transactions in one's own stock is not a gain or loss and therefore cannot be classified as part of earned surplus. Nevertheless, legal authorities say that the clarity of the Model Business Corporation Act will be lacking on this point until the courts decide the issue.\textsuperscript{18}

Some state statutes are more explicit than the Model Act. For example, Wisconsin's revised corporate statute specifically excludes gains on treasury stock from earned surplus.\textsuperscript{19} New York's revised statute also prevents earned surplus from being increased by any gains on treasury stock transactions.\textsuperscript{20}

Accounting for Treasury Stock

\textbf{Acquisition of treasury stock.}--The legal concept concerning treasury stock is that stock may be purchased only "out of" corporate surplus. The underlying reason for this viewpoint is that the firm should always maintain its


\textsuperscript{19}Ibid.

\textsuperscript{20}New York Business Corporation Law, Secs. 515 & 517 (a) (5).
stated capital. In order to prevent any impairment, treasury stock purchases are limited to the amount by which owners' equity exceeds stated capital. This procedure guarantees that owners' equity cannot fall below stated capital as a result of treasury stock acquisitions.  

The details of state statutes regarding treasury stock vary from state to state. However, treasury shares can be purchased in all states at least to the extent of any unrestricted earned surplus. Capital surplus can also be used as a basis for acquiring treasury stock although some states require stockholder approval. Under certain conditions, corporations can even purchase their own stock when there is no surplus of any kind. Some of the conditions are to buy fractional shares, to satisfy dissenting stockholders under certain circumstances, and to buy redeemable stock (stock that has a redemption feature).

Upon purchase of a corporation's own stock, the conventional procedure is to reduce a surplus account for the cost of the acquisition. This action is specifically


22California Corporations Code, Sec. 1707; Texas Business Corporation Act (1955), Art. 2.03.

23California Corporations Code, Sec. 1706; Texas Business Corporation Act (1955), Art. 2.03; New York Business Corporation Law, Sec. 513.
directed by some state codes\textsuperscript{24} while in some other states
this procedure is implied by the phrase that treasury
shares may be purchased "out of" a given surplus.\textsuperscript{25}

However, the effect on surplus is not as clear in
the statutes of states which have patterned their law on
the Model Business Corporation Act. Although it may not
have been the intention of the drafters of the Model Act,
the Model Act seems to result in a double effect on surplus.
The Model Act is silent about reducing any surplus for the
cost of treasury stock. However, owners' equity has been
decreased, and the reduction of some owners' equity com-
ponent is logical; an owners' equity account must be re-
duced to maintain the equality of assets and their sources
on the balance sheet. Because stated capital should not be
impaired, a surplus account must be reduced. So even
though the Model Act is silent on this point, surplus is
affected by the cost of treasury stock.

But to compound the matter, the Model Act states
that surplus is to be restricted for the cost of treasury
stock as long as the stock is held by the company. Thus,
the double effect is that surplus is reduced by the amount
of the purchase, and on top of the reduction, surplus is

\textsuperscript{24}California Corporations Code, Sec. 1709 as amended
by 1951, Chap. 1377, Sec. 1; Michigan General Corporation
Act, Sec. 10 as amended 1953, Act No. 156.

\textsuperscript{25}Hackney, op. cit., p. 1392.
also restricted by the cost of the repurchased stock.\textsuperscript{26} The double effect is probably not intentional, but instead, is an example in which corporate codes are not precise.

Disposition of treasury stock.--Upon the resale of treasury stock, procedures vary from jurisdiction to jurisdiction. In some states, the surplus account that was reduced by the stock purchase is restored to the extent of the consideration received upon the resale of the stock; any excess of the sales price over cost cannot be earned surplus.\textsuperscript{27} In California, the entire sales price is credited to capital surplus even though the earned surplus account is reduced for the purchase.\textsuperscript{28} And in the Model Act, the entire restriction apparently is lifted even when treasury stock is sold for less than its cost.\textsuperscript{29}

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\textsuperscript{27}New York Business Corporation Law, Secs. 515 & 517 (a) (5); Louisiana Business Corporation Law (1968), Sec. 62(D).


\textsuperscript{29}Hackney, op. cit., pp. 1394-95.
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Dividends

Accountants generally maintain that dividends should be paid only if there is retained earnings or earned surplus. A few states restrict dividends to the amount of earned surplus, but there are many exceptions.

In the Model Business Corporation Act, property dividends are payable "out of" earned surplus. However, capital surplus can be used as a basis for paying cumulative dividends on preferred stock if there is not any earned surplus. Quite a few state corporation codes follow the dividend recommendations as outlined in the Model Act.

Some states do not seem to have any restrictions against paying dividends "out of" capital surplus. However, some states do not allow the capital surplus paid in by one class of stock to be distributed to a class of stock that is junior to the contributing class. New York allows dividends to be paid from either capital surplus or

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32 Ibid., p. 261.
33 Virginia Code Annotated, Sec. 13.1-43(a) (Supp. 1956); Louisiana Business Corporation Law (1968), Sec. 63(A).
34 Garrett, loc. cit.
earned surplus; dividends can be paid from capital surplus even though there is a balance in earned surplus. However, if dividends are paid from capital surplus, stockholders must be notified of the fact. Consequently, the disclosure requirement prompts most New York corporations to declare dividends from earned surplus rather than capital surplus.  

Because some states do not separate surplus into capital surplus and earned surplus, dividends in these states can be based upon the entire amount of surplus.  

Some states do not allow property dividends to be based upon unrealized appreciation. However, the surplus arising from revaluation of the assets may be used as a basis for declaring stock dividends.  

Some states allow dividends to be paid on the basis of current earnings even though there is a deficit in the surplus accounts.  

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36 Delaware Code, Chap. 8, Sec. 170; New Jersey Revised Statutes, Sec. 14:8-19.  
37 Ohio Revised Code Annotated, Sec. 1701.33.  
Conclusions

Lack of uniformity among states.--If the legal basis of classification is to be used, the owners' equity section should be presented in accordance with the statutes of the state in which the business is incorporated. As is evident from the discussion, there are variations in the laws from state to state. Consequently, these variations hinder the uniformity in accounting for owners' equity. A transaction could be accounted for in several different ways according to the differing corporate statutes among the states.

Incompleteness of statutes as a guide for accounting.--State corporate statutes were not drafted with the intent of being an accounting handbook. Instead, the laws were written to protect the corporations' creditors. As a result, the statutes are oftentimes incomplete in spelling out the procedures to be used in measuring and accounting for the owners' equity. For instance, corporate statutes do not tell how the assets or owners' equity should be valued (at cost or some other basis) nor how the profits, losses, and gains are to be computed. As has been seen, state codes are sometimes silent or vague about the classification of some items. As was noted earlier, one guideline of classification is that the classes should be defined so there cannot be any doubt as to what group an item belongs. In this respect, state corporation statutes are sometimes inadequate and incomplete for accounting purposes.
Classification by Sources of Owners' Equity

There have been numerous suggestions that owners' equity be classified on the basis of its sources or origins. As suggested by several writers, owners' equity can be classified into the following sources: (1) capital paid in by the owners, (2) undistributed earnings, (3) donated capital, and (4) revaluation of the assets. The items to go in each category should not be influenced by their legal characteristics.

The four classifications are self-explanatory although paid-in capital should be amplified a bit. Paid-in capital includes the entire amount of proceeds received upon the issuance of stock. This includes premiums as well as the par or stated value of the stock. Paid-in capital also includes gains on the sale of reacquired stock, gains on the retirement of stock, and paid-in amounts resulting from the conversion of securities.

The division of owners' equity into the four sources


as mentioned is an arbitrary classification. The sources of owners' equity could be contracted into fewer source classes or expanded into additional ones. For example, donated capital could be eliminated by classifying all gifts as paid-in capital. Or appraisal capital could be classified as a revaluation of paid-in capital and retained earnings. Following these two suggestions, all owners' equity could be classified as either paid-in capital or retained earnings. For this study, however, the four-source classification will be used.

Increases in Owners' Equity

Unprecise definition of classes. - Most increases in owners' equity can be attributed to one of the four sources. There are, however, a few increases in owners' equity which do not distinctly fall into any one of the sources because the classes are not exhaustively defined.

One example is the classification of a bona fide gift of property from a stockholder. Its classification is not clear because it can fit into two classes: paid-in capital by an owner, and donated capital. However, the solution is quite simple: the classes need to be well defined.

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Hendriksen, loc. cit. The difficulty in determining the allocation between paid-in capital and retained earnings makes this method impractical.
In this case, the donated capital class could be restricted to gifts only from outsiders, and the gift by the owner would then be classified as part of the capital invested by owners. An alternative is to define donated capital so that it includes gifts from outsiders and owners, and paid-in capital would refer only to capital in which there was an exchange of property or service for an ownership right.

The important point is that each class be defined so that there is no question as to how an item should be classified. The result is that items will be classified consistently. Furthermore, statement readers will have a better understanding of what each class represents.

Stock options.--The sources of owners' equity are misstated if executive stock options are accounted for incorrectly. There is general agreement that a stock option is a form of compensation, but the major difficulty is establishing the amount of compensation.

A stock option represents a source of paid-in capital. The executive agrees to provide services in return for ownership in the firm. Instead of giving cash or property as most stockholders do, the executive gives his services as partial payment for the stock.\footnote{Daniel L. Sweeney, Accounting for Stock Options (Ann Arbor, Mich.: Bureau of Business Research, School of Business Administration, The University of Michigan, 1960), pp. 179-85.} The services
become an asset of the firm and are eventually matched against the revenues. To account properly for the stock option, the services and paid-in capital must be recognized. Because of the difficulty in determining the value of the services, most companies do not record stock options. Neither the services nor paid-in capital is ever recognized. Consequently, the paid-in capital is understated. And because the services are never recognized, the expenses are understated and, thus, cause an overstatement of retained earnings equal to the value of the services. The effect is to misclassify the source of owners' equity arising from stock options. The owners' equity attributed to earnings is too high, and the paid-in capital is too low.

Numerous methods have been suggested for establishing the value of the services, but none of them has gained any general acceptance in practice. The analysis of the alternative methods is complex and is not undertaken here. The major point to be stressed is that the sources of owners' equity are misstated if executives' services are not recognized as a source of paid-in capital.

Transfers between Sources

Under the source basis of classification, there would not be any transfers of owners' equity from one
source to another. This pertains especially to stock dividends and quasi-reorganizations.

**Stock dividends.**—Under presently accepted accounting principles, a stock dividend is accounted for as a transfer of retained earnings to the capital stock and premium accounts. This procedure is consistent with the legal provisions. However, it misstates the amount of owners' equity that was put into the firm by stockholders and the amount of the earnings which have been retained by the firm. To avoid this misstatement of owners' equity by source, there should not be any reclassification of owners' equity for stock dividends.

**Quasi-reorganizations.**—The conventional method of accounting for a quasi-reorganization also transfers owners' equity to another.

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However, there is not complete agreement on this point. The Accounting Terminology Bulletins and several reports of the American Accounting Association endorse the source basis, too, but they maintain that transfers from retained earnings to paid-in capital should be made for stock dividends, recapitalizations, and other appropriate actions. See Committee on Terminology, op. cit., pp. 29-30; American Accounting Association, op. cit., pp. 57, 63.

In this study, the concept to be used is the one in which there are no transfers among sources.

44 Hendriksen, op. cit., p. 423.
equity from one source to another. In the usual case, a deficit is eliminated by offsetting it against invested capital. When the firm subsequently begins to earn a profit, the income becomes retained earnings and is not diminished by the previous deficit. Consequently, the owners' equity section misstates the amount of capital which came from the various sources. The capital contributed by the owners is understated whereas the earnings accumulated by the firm are overstated. To avoid the distortion, there would not be any accounting entry for a quasi-reorganization under the source basis of classification. 45

Difficulty of Relating Decreases in Owners' Equity to Specific Sources

If the owners' equity section is to be classified according to sources, all decreases must be charged to some source of owners' equity. Some well-established concepts in accounting are that the retirement or redemption of stock and the payment of liquidating dividends are returns of paid-in capital. Cash and property dividends, losses from business operations, and the excess of cost over the paid-in capital of retired and redeemed stock are considered to be distributions of earnings. 46

45 Ibid., p. 440. Also refer to footnote 43.
46 American Accounting Association, op. cit., p. 63.
Homogeneity of owners' equity.--The relationships just cited are not as absolute and irrefutable as the ones for increases of owners' equity. When owners' equity increases, the source or reason for the increase can be identified. However, all owners' equity is homogeneous, and subsequent decreases in owners' equity cannot be identified with the equity arising from some specific source. In this sense, owners' equity is analogous to water that is being poured into a tank at the rate of one gallon per day. Because the water in the tank is homogeneous and commingled, water added on one day cannot be distinguished from the water added on another day. Consequently, if a gallon of water were removed from the tank, it would be impossible to ascertain exactly how much water from each day's addition was removed.

The analogy is applicable to owners' equity. At the time that owners' equity is increased, the source of the addition is evident; the increase can be attributed to an investment of capital by an owner, a gift, or the result of profitable operations. After its entry into the business, owners' equity can no longer be traced according to its source. Every increment of owners' equity, regardless of its source, is identical to all other owners' equity; owners' equity that comes from earnings is identical to owners' equity that is invested by stockholders. Consequently, when there is a decrease in the total amount of
owners' equity, relating the decrease to any particular source of equity is impossible. 47

Dividends.--Even though decreases of owners' equity cannot be identified with a specific source, accountants have usually assumed that there are certain relationships between decreases and the source that is affected. One such assumed relationship is that dividends are a reduction of that part of owners' equity which came about from earnings. However, a different assumption could be made. For instance, a company could take the point of view that the periodical payments to stockholders are a return of the capital which was invested by the owners. The company could argue that its philosophy is to return the owners' investment before making any distributions of earnings.

Retirement of stock.--Another well-accepted assumption is that when a firm retires some of its capital stock, payment for the acquisition is considered to be a return of the capital paid in by the investor. If the payment to the stockholder exceeds the original investment, the excess represents a distribution of retained earnings. To

47 This idea is adapted from Maurice E. Peloubet, "Is It Desirable to Distinguish between Various Kinds of Surplus?" The Journal of Accountancy, LXV (April, 1938), 289-90. Peloubet was writing about surplus, but his arguments are equally applicable to the whole owners' equity section.
illustrate, assume that a corporation with 100 shares of outstanding stock has the following sources of owners' equity:

<table>
<thead>
<tr>
<th>Invested capital</th>
<th>$ 1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>3,000</td>
</tr>
</tbody>
</table>

The book value per share of invested capital is $10, and retained earnings per share is $30.

Assume that the above corporation purchases one share of stock for $35. Normally this transaction is made in the accounting records as reducing the invested capital by $10 and reducing retained earnings by $25. The usual assumption is that the stockholder has left $5 of retained earnings in the corporation.

However, the assumption could be challenged. One could argue that the $35 reduction of owners' equity represents a distribution of $30 of retained earnings (the book value per share) and $5 of invested capital. The stockholder has left $5 of his invested capital in the corporation.

There is still another variation upon the retirement of stock. Some accountants would reduce invested capital by $10 and reduce retained earnings by $25. In addition, the remaining $5 of retained earnings would be transferred to invested capital on the grounds that the retiring stockholder is allowing part of his equity to remain in the business and that this could be considered invested capital. The $5 is no longer considered to be an undistributed
equity in retained earnings. The net effect is the same as in the assumption that the retained earnings related to the canceled stock is distributed to the retiring stockholder before any of the invested capital is returned.

Treasury stock.--The previous illustrations center around two assumptions which are generally accepted: that dividends represent distributions of earnings; and that the retirement of stock represents first a return of paid-in capital, and if the payment exceeds the pro rata share of paid-in capital, the remainder of the payment is a distribution of earnings. However, there are some types of transactions in which there is no agreement as to which sources are affected. For example, the assumption as to what sources are affected by treasury stock transactions is not well established.

One method of accounting for the cost of treasury stock is to treat it as an unallocated deduction from owners' equity; neither paid-in capital nor undistributed earnings is specifically reduced for this decrease of owners' equity. The objection to this method is that the individual sources of owners' equity are overstated on the balance sheet.  

49 Hendriksen, Accounting Theory, pp. 435-36.
The alternative is to reduce paid-in capital and undistributed earnings for their pro rata amounts when treasury stock is purchased. When the stock is resold, the full amount of the proceeds must be regarded as paid-in capital; a deep-seated concept in accounting is that no retained earnings can originate from the transactions of a firm in its own stock. Consequently, when treasury stock is purchased at a cost in excess of its pro rata share of paid-in capital and is subsequently resold at a price equal to its cost, the net effect is to reduce retained earnings and increase paid-in capital. The major criticism of this procedure is that the sources of owners' equity are disturbed when the transaction is, in effect, a transfer of stock from one stockholder to another. Critics say that the company is merely acting as a middleman or broker for the stockholders. Thus, the transaction should not have any effect on the sources of owners' equity except to the extent that the treasury stock is sold for more or less than its cost. These critics favor treating treasury stock as an unallocated reduction of total owners' equity.50

As is seen, there are two differing concepts in accounting as to the sources of owners' equity that are affected by the purchase of treasury stock. One group regards the acquisition as a contraction of the capital

structure, that is, as a reduction of both invested capital and undistributed earnings. The purchase of the treasury stock is considered to be a cancellation of the acquired stock although the corporation has not formally canceled the shares. The second viewpoint is that the cost of the treasury stock is in a temporary state of suspense during its transfer from one stockholder to another. This viewpoint maintains that the sources of owners' equity are not changed.

In addition, the legal concept offers still another assumption about treasury stock. The legal assumption is that treasury stock represents a reduction of earned surplus. This legal viewpoint has apparently been accepted by some accountants. In his article advocating the classification of owners' equity by source, Lowe states that the cost of treasury stock is a reduction of retained earnings.

Conclusions.--In these illustrations (dividends, cancellation of stock, and treasury stock), there is no way to prove which sources of owners' equity are actually decreased by the transactions. The source components of owners' equity cannot be independently verified or measured in the same manner that components of total assets or total

51 Supra, pp. 55-56. 52 Lowe, loc. cit.
liabilities can be determined. For instance, cash can be counted, accounts receivable can be confirmed, and fixed assets can be visually inspected. But there is no way to independently verify, count, or visually inspect the amounts of an owners' equity balance which came from various sources. Assertions about reductions of owners' equity stemming from different sources cannot be validated by any natural proof.

If the source basis is to be the principle for classifying owners' equity, the artificiality of attributing decreases of owners' equity to specific sources must be recognized. Furthermore, the assumptions concerning the sources that are affected by different types of transactions must be generally accepted. Without general acceptance, there would not be any uniformity in the reporting of owners' equity from company to company. A lack of agreement regarding the assumptions could also result in uncertainty and confusion on the part of the statement readers.

Classification of Owners'
Equity by Investors

In partnerships, the owners' equity can be classified according to the equity of each partner. In corporations with more than one class of stock, the owners' equity can be classified according to each class.

Allocating the owners' equity among the partners is rather simple. However, the allocation problem is more complex for corporations.
Equities of the Partners

In the case of partnerships, the method for computing each partner's equity is found in the partnership agreement. The agreement usually indicates how the profits and losses are to be allocated. By adding the partner's share of profits to his investment and subtracting his withdrawals and his share of losses, each partner's equity can be calculated. The results represent the legal interests of the partners.

Corporations

In corporations, there are several values which might be used for determining the equity of each class of stock. In all these cases, the equity of the senior stock is determined first. Any residual of owners' equity is then assigned to the most junior stock. The values which can be used for determining the equity of the preferred stock are the par or stated value, the capital paid in by the preferred stockholders, and the redemption and liquidation values.

Par or stated value.--The value at which preferred stock is usually reported in balance sheets is at its par or stated value. The residual of the owners' equity belongs to the common stock. In this method, any premium paid in by the preferred stockholders becomes part of the common stock equity.
Paid-in capital.--Another way of measuring the equity of the preferred classes of stock is by the amount of capital they invested in the firm.\textsuperscript{53} After the paid-in capital contributed by all senior stocks has been assigned, any residual of owners' equity would be the equity of common stock. In most instances, the common stock equity would be equal to its own paid-in capital plus earnings less any losses and dividends. Common stock equity would also be increased by the donation of assets from outsiders.

One point which needs to be mentioned is the redemption of senior shares of stock. If a senior share is redeemed for less than its paid-in amount, the question arises as to whether the difference should be an equity of the preferred stock or the common stock. To illustrate, assume that a preferred share had been issued for $102 and subsequently redeemed for $100. From one point of view, the $2 difference represents capital that has been left in and contributed to the firm by a preferred shareholder. Because the amount was left in by a preferred stockholder, the amount could be considered as a part of the preferred stock equity. On the other hand, the amount is not associated with any preferred share that is currently outstanding, and thus, the $2 could be part of the common stock equity.

equity.

The most desirable solution emerges when the entire preferred issue is redeemed for an amount less than the original investment. To show the difference as an equity of preferred stock would be absurd when the preferred stockholders have absolutely no rights, claims, or interest in the corporation. The desirable solution is to credit the common stockholders' interest with any surplus arising from preferred stock redemptions. According to Paton, this is a shift of invested capital from the preferred stock equity to the common stock. 54

When preferred stock is redeemed for more than its paid-in amount, the excess should not be charged against the paid-in surplus of the preferred stock. If the preferred stock were charged, the outstanding preferred stock would be presented at an amount less than actually paid in by such shares. 55

Liquidation and redemption values.--Another basis for determining the equity of preferred stock is its liquidation value. This value emphasizes the "destination" of owners' equity. 56 Sometimes there are two liquidation

54Paton, Accounting Theory, p. 537.
values, one which is applicable in case of voluntary liquidation while the other is applicable to involuntary liquidation.

In some cases, the preferred stock is more likely to be redeemed rather than liquidated. Therefore, the redemption value may be a more realistic figure representing the amount that preferred stockholders will receive from the corporation for their stock.

**Comparison of the par, redemption, and liquidation values.**—In some companies, the equity of a corporation's preferred stock is about the same amount under each of the several valuation methods. For instance, the 3 3/4% cumulative preferred, series A stock of Standard Oil Company of Ohio has par, redemption, and liquidation values all at $100.57 (The annual report does not indicate the amount of capital paid in by the preferred stockholders.)

On the other hand, the values differ considerably for some stocks. The preferred stock of Consolidated Foods Corporation has a dividend rate of $4.50 and a stated value of only $3.12 1/2. The stock is redeemable for $110 to $100 depending on the date of redemption. In voluntary dissolution the stock pays $100; if the dissolution is

involuntary, the liquidation value is only $40.\textsuperscript{58}

In valuing the preferred stock equity for some companies, the choice of the valuation basis is not critical because a similar valuation would result no matter which basis is chosen. But in some other companies, the choice would be quite significant. In Consolidated Foods Corporation, the equity of preferred stock would be thirty-two times larger if the redemption value basis were used rather than the stated value basis.

Dividends in Arrears

Equity of preferred stock.--The presentation of preferred dividends in arrears has always been a problem. In some ways, accountants have felt that the arrearage is part of the preferred stockholders' equity. One evidence of this is in the computation of the book value per share for stock. The computation usually treats the dividend arrearage as part of the preferred stockholders' equity. In statement presentation, however, there has been a hesitancy to add the arrearage to the equity of the senior classes of stock. The reason usually cited for this viewpoint is that the preferred shareholders have no legal claim to the dividends until they are declared by the board of directors.\textsuperscript{59}


\textsuperscript{59}\textit{Paton and Paton, Corporation Accounts and Statements}, pp. 116-17.
The lack of a legal declaration of dividends should not prevent the inclusion of the dividend arrearage in the preferred stock equity. Furthermore, a justification for including the dividend arrearage in the preferred stockholders' equity is that the amount would otherwise become part of the common stock equity. There is less justification for allowing the arrearage to be part of the common stock equity than of the preferred stock equity. After all, no dividend declaration has been made to give any legal interest in the retained earnings to the common stockholders, either. However, since the intention is to allocate the entire amount of retained earnings to the several classes of stock, dividends in arrears should be allocated to the preferred stock equity. The senior shareholders have priority to the earnings.

When the amount of assets paid in by the preferred shareholders is the basis used in determining the preferred's equity, dividends in arrears definitely should be included in the preferred stock equity. The dividends in arrears indirectly represent amounts that have been contributed by the preferred stockholders; the corporation is using assets that it otherwise would not have. In the sense used in Chapter II, the dividends in arrears represent a source of assets contributed by the preferred stockholders.
Liquidation and dividends in arrears.--If the redemption or liquidation values are used to measure the equity of preferred stock, the status of the arrearage can be found in the articles of incorporation. The provisions pertaining to preferred stock often require that any dividends in arrears be paid in addition to the redemption or liquidation values. In such a case, the balance sheet presentation should include the dividends in arrears as part of the preferred stockholders' equity.

The question arises whether or not the preferred shareholders are entitled to any arrearage when there is not any surplus legally available as a basis for declaring dividends. The situation apparently differs from state to state and depends upon the liquidation provisions given to preferred stock in the articles of incorporation. In those instances where preferred stockholders cannot recover dividends in arrears when there is a lack of any surplus, the preferred stock equity presentation in the balance sheet should exclude the arrearage. But in other states, dividends in arrears can be "paid from" stated capital at liquidation. In such a case, the preferred stock equity should include the arrearage.

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Classification by the Restrictions on Owners' Equity

Owners' equity is subject to various restrictions, and these restrictions may be a basis for classifying owners' equity. The restrictions most frequently considered for classification are those which limit the distribution of corporate assets to the investors. These restrictions are sometimes significant because they offer a partial explanation of a firm's dividend policy.

Restrictions on the distribution of owners' equity arise in four ways. The four are: state corporate statutes, articles of incorporation, contractual agreements, and decisions of the directors. These four restrictions are discussed.

Types of Restrictions

Statutory restrictions.—As was seen in an earlier section, state statutes place limitations on the withdrawal of assets by the owners. Stated capital requires that a minimum amount of owners' equity be maintained. In some states, capital surplus cannot be used as a basis for paying dividends to the preferred stockholders. In other states, capital surplus imposes no limitations on asset distributions. Earned surplus usually is available as a basis for distributions although treasury stock and the possibility that a firm will be unable to pay its
liabilities put limitations on the earned surplus. However, these legal limitations are sometimes circumvented. For example, the stated capital can be reduced without much difficulty, thereby increasing the capital surplus which can be used as a basis for distribution in some states. And in several states, dividends can be paid on the basis of the current year's earnings although there is a deficit in the earned surplus. 62

Contractual limitations.--Restrictions are also contained in the articles of incorporation and in contractual agreements with creditors. 63 These may require, for instance, that dividends be limited to profits earned after a certain date or to an amount which would not allow the current ratio to fall below a certain level. 64

Restrictions of the directors.--The board of directors has the prerogative of restricting retained earnings. However, if the directors make any explicit restrictions, such limitations seldom appear on the balance sheet. Of

62 Supra, pp. 47-60.
the six hundred companies surveyed in Accounting Trends and Techniques, there were only nine firms which showed any specific appropriation of retained earnings in 1967. Of these appropriations, several probably represented appropriations initiated by the directors. In the same year, 411 of the companies mentioned restrictions on the limitations of dividends. However, all of the 411 restrictions pertained to debt and preferred stock and were probably contractual limitations. The evidence would seem to indicate that the corporate directors seldom impose any explicit restrictions on retained earnings.

Although the board of directors might not explicitly restrict retained earnings in the balance sheet, other actions of the board imply a restriction. The failure of the directors to declare dividends when there are unappropriated retained earnings implies a restriction. One case in point is Control Data Corporation. In a listing application to the New York Stock Exchange, Control Data Corporation points out that it had never paid a dividend on its common stock and that dividends would not be paid in the future as long as the company needs to conserve its cash. The cash is needed for expansion of operations.

66 Ibid., pp. 231-33.
Despite this statement of policy, the financial report of that year does not mention this restriction which the company has placed on dividend declarations. 69

"Practical" restrictions.--Even though there may not be any explicit restrictions that are imposed by creditors or the directors, there is a practical restriction on retained earnings. In many firms, the retention of earnings is a major source of assets; a large part of the firm's expansion has been made possible by the retained earnings. The firm could not distribute its entire retained earnings as dividends without seriously liquidating some of the operations. From a practical point of view, most of the retained earnings should be considered a permanent investment in the firm. In essence, this part of retained earnings is restricted as to dividend payments. This practical limitation is probably more significant than any other restriction; yet it is never mentioned in financial reports.

Basis for Determining Restrictions in Classification

The question arises as to which types of restrictions should be used in the classification of the owners' equity section.

One problem is that the concept of unrestricted

owners' equity is unclear. On one hand, unrestricted owners' equity could signify the amount of owners' equity which is not legally restricted and is therefore available as a basis for declaring dividends.\textsuperscript{70} This concept says nothing about the firm's asset availability or willingness to pay dividends. A second interpretation is that unrestricted owners' equity is "the portion of earned surplus matched by liquid assets not needed in the business--a measure of immediate dividend possibilities."\textsuperscript{71} According to Paton, the latter concept is more significant. It gives the statement reader a better basis on which to judge a firm's dividend policy.\textsuperscript{72} The managerial and practical restrictions would be included as restrictions in the latter concept.

But a practical difficulty arises from using the managerial and practical restrictions in classifying owners' equity. Business enterprises would probably be reluctant to label a portion of their owners' equity as available for dividends, yet retained in the business.\textsuperscript{73} Stockholders

\textsuperscript{70}Paton and Paton, \textit{Corporation Accounts and Statements}, p. 140.


\textsuperscript{72}Paton and Paton, \textit{loc. cit}.

would certainly demand that the available amount be dis-
tributed. From a practical point of view, only the statu-
tory and contractual restrictions should be used for classi-
fication purposes.

**Methods of Classification**

*Type of restrictions.*--The owners' equity could be
classified according to the types of restrictions. The
major classes would be stated capital, capital surplus, and
the restrictions on retained earnings imposed by contrac-
tual agreements and the board of directors. Any balance of
retained earnings would be classified as unrestricted.

One reporting difficulty may arise when classifying
retained earnings according to each separate restriction.
The sum of the individual restrictions may exceed the total
retained earnings. Assume, for example, that a firm has
total retained earnings of $10 million. The retained earn-
ings have a restriction of $4 million imposed by the bond-
holders. In addition, assume that the preferred stock-
holders have restricted the entire amount of retained
earnings. In this example, the total restrictions are $14
million. However, some of the restrictions are overlapping
and apply to the same $4 million of retained earnings. In
practice, however, only the most restrictive provision is
reported rather than listing each separate restriction. 74

Effect of the restrictions. -- Whenever there are two or more classes of stock, there may be more than one set of restrictions. Some of the restrictions apply to the senior class of stock whereas there may be additional restrictions that apply to common stock. There are several illustrations of this. In some states, capital surplus can be used to pay dividends only to the preferred stockholders; dividends to common stock cannot be based upon the capital surplus. Bond indentures sometimes set different dividend limitations on the common and preferred stock. 75 By their nature, common stock is restricted from receiving any dividends until the preferred stock dividends have been paid. And the board of directors may have two sets of restrictions; even though the company's policy is not to pay any dividends to common stock, the preferred dividends are faithfully paid. 76

74 For example, see Allied Products Corporation, Annual Report, 1967, note 6 to the financial statements, no page number; and Admiral Corporation, Annual Report, 1967, note C, p. 19.

75 The 3 5/8s bonds (due in 1976) of Kaiser Aluminum & Chemical Corporation limit cash dividends to profits earned after November 30, 1960. However, an additional $5,000,000 of retained earnings is available for preferred stock dividends. See Moody's Industrial Manual: 1968, p. 731.

76 For example, Control Data Corporation does not pay any dividends on its common stock. However, the dividends have always been paid on the preferred stock. See Control Data Corporation, Listing Application to the New York Stock Exchange, August 15, 1968, p. 12.
One conceivable method of classification is based upon the effects, in other words, on whom the restrictions of owners' equity apply. If there are two classes of stock, there would probably be three classes of owners' equity as follows:

1) owners' equity which cannot be distributed as dividends to any stockholders;
2) owners' equity which can be distributed as dividends to preferred stockholders but not to common stockholders; and
3) owners' equity which does not have any dividend restrictions.

The first class would consist of stated capital, capital surplus of corporations in states which do not permit any kind of dividend payments out of capital surplus, and retained earnings which cannot be used as a dividend basis to either group of stockholders. The second class would include capital surplus and retained earnings which can be used for declaring dividends to preferred stockholders only. The third class is obvious. However, it would include the amount which could be distributed as a current earnings dividend when there is a deficit in retained earnings; the stated capital in the first class should be reduced for the potential dividend.

The usual textbook approach to restrictions emphasizes the type of the restriction. For example, some owners' equity is restricted because it is stated capital or capital surplus. The retained earnings might be restricted because of contractual agreements, contingencies,
or other such purposes. However, the kind of restriction does not always tell who is affected. For instance, the capital surplus account does not indicate which stockholders, if any, are denied distributions of this surplus. Nor do the appropriations of retained earnings point out which groups of stockholders are affected by the restrictions.

Classification by Utilization of Owners' Equity

Owners' equity can be classified by its utilization or purpose in the business. This basis has often been mentioned in reference to retained earnings, but it could apply equally well to the entire owners' equity.

Essence of the Utilization Concept

In discussions on the appropriation of retained earnings, restrictions are often thought of as indicating the use of retained earnings. However, there is a fundamental difference between a restriction and the use of retained earnings. Restrictions emphasize the amounts of earnings which are not available as a basis for dividends; use stresses what has been done with the earnings that have been retained. To illustrate this point, stated capital is a restriction on distributions to stockholders, but stated capital does not tell how the capital has been used. Another example is a bond indenture which restricts the
entire retained earnings of a firm. The bond restriction does not indicate the use of the firm's retained earnings.

Methods of Classification

To classify owners' equity by its utilization requires that the relationship of owners' equity to particular groups of assets must be traced. Paton and Paton indicate how this might be done. However, the procedure is based upon several assumptions which, as the Patons note, are incapable of objective verification. The two major assumptions are (1) that current liabilities provide current assets, and (2) that long-term debt is used to finance long-lived assets. Any net current assets are regarded as having been provided by the owners' equity. Similarly, the owners' equity is regarded as having furnished the long-lived assets not accounted for by long-term debt.77

However, Myer disagrees with some of the assumptions of the Patons. Myer says that the owners' equity should be regarded as providing the long-lived assets. Thus, long-term debt provides the working capital and the long-lived assets not financed by the owners' equity.78

As is obvious, the method of classifying owners'

77 Paton and Paton, Corporation Accounts and Statements, pp. 138-40.
equity by its utilization is not clear-cut.

Two-Stage Classification of Owners' Equity

Definition of the Two-Stage Concept

Thus far, classification of the owners' equity section has been carried out to only one stage. A one-stage classification is a simple division of owners' equity into several classes based upon one classification principle. However, classification can proceed to a second level by subdividing the classes that were derived in the first stage. In the illustration below, the first level of classification is

\[ \text{A} \quad \text{B} \]

\[ \text{C} \quad \text{D} \quad \text{E} \quad \text{F} \quad \text{G} \]

into classes A and B. The second level of division subdivides classes A and B into subclasses C, D, E, F, and G. In theory, the principle of classification that was used in the first level can also be used in the second stage, or a new classification principle can be employed.\(^\text{79}\)

Use of the Same Classification Principle in Both Stages

To use the same principle in both stages is rather difficult, if not impossible, in classifying owners' equity. For example, the corporate codes divide owners' equity into only stated capital, capital surplus, and earned surplus. There is just not any additional basis in the statutes on which to subdivide these three components.

The source basis can easily subdivide paid-in capital into whether it came from common or preferred stockholders. Returns of capital to these groups can be identified when stock is retired. But subdividing retained earnings into ordinary and extraordinary sources encounters a major difficulty. The problem is identifying and charging decreases of retained earnings to one of its two sources. Assumptions would have to be made as to whether dividends are being paid from ordinary income, extraordinary profits, or both.

The same difficulty would apply to any distributions of retained earnings when retiring stock. As was seen in the discussion on sources of owners' equity, the division of sources at the first level is quite tenuous. To subdivide the sources a second time would require even more questionable assumptions, some which might not be generally accepted by the business community.

The classification by types of investors cannot be
carried beyond one stage, either. Because each share of stock is identical to another of the same class, there is no way to differentiate the equity of a stock class into smaller, differentiated groups. If all the items in a group are identical, there is not any way to subdivide them.

Use of Different Principles in Each Stage

Basic illustration.--Using a different classification principle at each level is easier than using the same principle at both stages. A two-stage classification that has been suggested by several writers uses the source basis at the first level and the legal principle at the second level. An illustration is shown.

Owners' Equity

Paid-in Capital:
- Designated as stated capital
- Capital surplus
- Total Paid-in Capital

Retained Earnings:
- Designated as stated capital
- Designated as capital surplus
- Earned surplus
- Total Retained Earnings

Donated Capital:
- Capital surplus
- Total Owners' Equity

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The illustration shows how a stock dividend would affect the owners' equity section. Under the source basis, no transfer should be made between the retained earnings and paid-in capital. Therefore, the capitalization of the retained earnings would have to be shown in the retained earnings section. The retained earnings section indicates the amount that is designated as stated capital and capital surplus. By necessity, the stated capital is separated and shown in two different places. The same also applies to capital surplus.

Effects of treasury stock transactions. -A two-stage classification can sometimes result in an illogical presentation of data. Assume that a firm with paid-in and stated capital of $100 and retained earnings of $50 purchases $30 of treasury stock at a cost equal to its book value. Under the source basis, a treasury stock transaction can be regarded as a pro rata return of paid-in capital and retained earnings. The distributions in this example are $20 and $10 respectively. The remaining balance of paid-in capital is $80, and the balance of retained earnings is $40.

From a legal viewpoint, the entire cost of treasury stock is a reduction of earned surplus. Thus, the remaining balance of earned surplus is only $20. The stated capital is not changed by a treasury stock purchase.
The presentation of the owners' equity section showing both the source and legal components would be as follows:

<table>
<thead>
<tr>
<th>Paid-in Capital:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated capital</td>
<td>$80</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Retained Earnings:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated capital</td>
<td>$20</td>
</tr>
<tr>
<td>Earned surplus</td>
<td>20 40</td>
</tr>
<tr>
<td>Total Owners' Equity</td>
<td>$120</td>
</tr>
</tbody>
</table>

The treatment of stated capital should be noted. The stated capital is larger than the paid-in amount. Thus, some of the retained earnings must be regarded as stated capital so that the full amount of stated capital is shown. However, this presentation is misleading because it appears that the firm's stated capital was originally $80 and that the board of directors has formally capitalized $20 of earned surplus.

Another awkward situation results when the treasury stock is resold. Assume that the treasury stock is resold for $30 and that the state statutes allow a restoration of the earned surplus that was reduced when the treasury stock was purchased. The amount of the earned surplus would go back up to $50. Under the source basis, the $30 would be regarded as paid-in capital. Added to the prior balance, the new amount of paid-in capital is now $110. To correctly show the sources of capital and their legal characteristics, the owners' equity section would have to be presented as follows:
<table>
<thead>
<tr>
<th>Paid-in Capital:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated capital</td>
<td>$100</td>
</tr>
<tr>
<td>Earned surplus</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>$110</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Retained Earnings:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned surplus</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>$150</td>
</tr>
</tbody>
</table>

The peculiar consequence is that part of the paid-in capital has to be classified as earned surplus. The result is alien to accounting thought because earned surplus cannot be contributed to a firm.

**Summary**

There are many possible combinations that could be used in classifying owners' equity. However, the one which has been illustrated brings out several important points. Subdividing owners' equity at a second level provides more information to the statement reader. At the same time, though, the owners' equity section becomes more difficult to read. This is because some components of owners' equity must be separated and shown in two different locations. Statement readers may misinterpret the full amount of the component because they overlook one of the amounts. A second effect of a two-stage classification may be a clumsy and even misleading presentation of the owners' equity as was illustrated with the treasury stock.
Retained earnings is a component in several of the classification bases which have been described. In all of the bases which use retained earnings as a class, the income concept plays a significant role in classification.

The income concept governs the classification of many transactions which affect owners' equity. For example, donations of property received by business firms are not considered to be income under the present income concept and, therefore, are not classified as part of retained earnings. Consequently, donations must be classified in some other component of owners' equity. On the other hand, if the income concept were expanded to include donations, donations would be classified as part of retained earnings rather than as capital surplus (under the legal concept) or donated capital (under the source basis). In other words, the classification of many items of owners' equity depends upon the income concept.

According to classical thought, income is defined as the increase in the wealth of a business entity. However, accountants do not abide strictly by this definition. For instance, gifts, stolen property, findings, and gains from illegal activities all result in increases in a firm's wealth, but normally, accountants do not consider these to
be parts of income. Because these increases of owners' equity are not considered to be income, they cannot be classified as part of retained earnings. Instead, the increases must be classified under some other components of owners' equity.

The significance of the present concept of income seems to be as a gauge of managerial performance or effectiveness rather than as a measurement of the increase in wealth. This is exemplified in the matching process in which the accomplishments are compared with the efforts that were used to acquire the revenues. Underlying the income concept is the notion that income must be created or earned. Only those operations and events which are related to the utilization of the firm's resources are included in the income. All other activities are excluded.

The concept of income changes over time to meet the needs of the economic and social environment. To illustrate, the income concept in England at one time excluded from income the gains and losses on the sale of fixed assets. The idea behind this exclusion was that income arises only from the use of the fixed assets, not from trading them. This concept had its roots in English law.

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82 Ibid.
where the corpus was passed intact from generation to generation. The corpus, consisting primarily of land, was rarely sold. But if the land were sold, the gain or loss was regarded as an adjustment of the corpus. The life tenant was entitled to spend only the income produced by the corpus. But the economic situation was different in the United States. In this growing country, there were profitable opportunities in land speculation. Some people became wealthy by buying and selling land rather than by putting the land to productive use. As a result, the American concept of income has included capital gains and losses as part of income.

The point to be emphasized is that the income concept plays an important role in determining how some items are to be classified. Furthermore, the classification of some items may have to be modified as the income concept changes. If the income concept becomes more restrictive, items formerly classified as retained earnings will be classified into some other category of owners' equity. Conversely, if the income concept is broadened, retained earnings will include items which were formerly in some other group of owners' equity.

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Summary

Five methods for classifying owners' equity have been discussed in this chapter. Their components, feasibility in classifying, and their implications were studied. In addition, the two-stage method of classifying owners' equity was examined. The effect of the income concept on classification was also seen.

Statutory Classification

The three components usually found in legal classification are stated capital, capital surplus, and earned surplus. The corporate statutes of each state are the authoritative sources for particulars in classifying the owners' equity. Classification by this principle is generally feasible although there are some transactions in which the statutes are silent or unclear regarding classification.

Classification by Sources

The source basis classifies owners' equity according to its origins. The most common sources are paid-in capital and retained earnings. Increases in owners' equity can usually be attributed clearly to a specific source. Decreases, however, are not as clearly related to any source. For classification purposes, assumptions are made as to the sources that are decreased by various kinds of transactions.
These assumptions usually reflect the financial flows and relationships as they are perceived by the business world.

**Classification by Investors**

The owners' equity section can be classified according to the equity of each partner or each class of stockholders. But for corporations with more than one class of stock, there is no clear-cut way of determining the equity of each class. Four methods of valuing the preferred stock are by its par value, liquidation value, call price, and the capital paid in by preferred stockholders. All four of the values might be different. Any remaining equity is assigned to the common stock.

**Classification by Restrictions**

Owners' equity can be classified into its restricted and unrestricted parts. Only the statutory and contractual restrictions should be taken into consideration for classification purposes. One way of classifying the restrictions is by their types, such as stated capital, capital surplus, or bond indenture agreements. However, the type of restriction does not indicate the effects of the restriction (such as when capital surplus can be distributed) or to whom the restrictions apply (to common or to preferred stockholders). Classifying the effects of the restrictions on various groups of stockholders is probably the most informative method.
Classification by Utilization

The utilization basis attempts to show how the owners' equity has been employed in financing working capital and long-lived assets. This basis requires several assumptions as to the relationships between equities and assets. At the present time, no one set of assumptions is generally accepted by the financial community.

Two-Stage Classification

If the owners' equity section is subdivided into more than one stage or level, two principles of classification can be used simultaneously. However, the two principles must be used at separate stages. This method presents more information than when only one principle is used. However, the possibility exists sometimes that there are fundamental differences between two principles, and consequently, the presentation of owners' equity can be illogical or awkward.

Income Concept

The income concept automatically dictates how revenue and expense items shall be classified. If the income concept changes, this causes corresponding changes in the classification of some items of owners' equity.
CHAPTER IV

THE USES AND IMPORTANCE OF OWNERS' EQUITY
TO THE READERS OF FINANCIAL STATEMENTS

As has been seen, owners' equity can be classified in many different ways. However, all these ways may not be equally valuable; some are more useful than others. One of the steps in evaluating the classification bases is to consider the needs of the people who use the data.

The purpose of this chapter is to examine the importance of owners' equity to the readers of financial statements and to examine how the readers use or interpret owners' equity in making their decisions. Among the topics to be explored are the uses of owners' equity in financial ratio analysis, the use of owners' equity in predicting future dividends, and the role of owners' equity in studying earning power.

The Users of Financial Statements

Primary Users

There are numerous users of financial information. Among the major users are the firm's management, stockholders and potential investors, creditors, and
governmental agencies. These four groups have different purposes in using financial data. Consequently, one set of financial statements may not emphasize or contain the information that is best suited for each user to accomplish his needs.

However, all these groups do not need to rely upon published annual reports for their information. For instance, management already has access to all the data that is generated by the firm's own information systems. Management, therefore, has no need to rely on its own published reports for information. Neither do governmental agencies depend upon published financial statements for data. Governmental agencies have the power and usually require special purpose reports to be prepared in accordance with the needs and purposes of the agency.¹

By excluding management and governmental units, the two major users of corporate financial reports are creditors and investors. Obviously, there are other users such as competitors, trade associations, and unions. However, the latter-named groups are probably not principal users. For purposes of this study, the investors and creditors are

considered as the major users of financial statements.

Purposes of Financial Statement Readers

The creditors are primarily interested in how well the firm will be able to pay its obligations as they come due. In the short run, the firm's current liquidity is the most relevant indicator of debt paying ability. In the long run, the capital structure and the firm's future profitability are important factors. In analyzing the firm's financial statements, the creditors are looking primarily for a margin of safety.

The owners must also be concerned about the debt paying ability and the solvency of the firm. However, the stockholders are usually more interested in the profitability of the firm. Stockholders are also concerned with the amount of dividends which the enterprise may pay.

The Use of Owners' Equity in Financial Ratio Analysis

Both the creditors and investors take owners' equity into consideration when evaluating a business enterprise. One of the primary methods in which owners' equity is used is in the preparation of financial ratios and statistics.

Ratios in Which Owners' Equity Is Used

To determine specifically how owners' equity and its components are used in financial ratios, the literature on financial analysis was surveyed. The literature that was
surveyed consisted of six texts on financial statement analysis, six books on investment principles, and four accounting texts. In addition, the standard ratios that have been published by Dun & Bradstreet, Robert Morris Associates, and Troy were included in the survey.

The following financial ratios were found which used owners' equity or a component in the computation of the ratios. The ratios are grouped according to their similarity.

**Capital Structure Ratios**

- Owners' equity to total liabilities
- Owners' equity to total capital (including all liabilities and owners' equity)
- Owners' equity to total assets
- Total liabilities to owners' equity
- Funded debt to owners' equity
- Current liabilities to owners' equity
- Unsubordinated debt to capital funds (tangible owners' equity plus long-term subordinated debt).

Capital structure percentages:
- Percentage of funded debt to total of funded debt and owners' equity
- Percentage of preferred stock equity to total of funded debt and owners' equity
- Percentage of common stock equity to total of funded debt and owners' equity

**Profitability Ratios**

- Net income to owners' equity
- Net income to total capital
- Rate of return on common stock equity (when there are two or more classes of stock)
- Net income before taxes to owners' equity

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2 See Appendix I for a list of the sources that were reviewed.
Fixed Asset Ratios

Fixed assets to owners' equity
Owners' equity to fixed assets
Owners' equity to non-current assets

Book Values

Book value per share--common stock
Asset protection per bond (total bond liability and owners' equity divided by the number of bonds outstanding)
Asset protection per share of preferred stock (total owners' equity divided by the number of preferred shares outstanding)

Miscellaneous Ratios

Net sales to owners' equity
Surplus to capital stock

In most of the ratios, tangible owners' equity can be used in place of owners' equity. Dun & Bradstreet, for instance, never use total owners' equity; instead, tangible net worth is always used.

All the above ratios or their variations were found in several sources with the exception of the ratio of surplus to capital stock. The surplus-to-capital-stock ratio was found in only one source.

3 One ratio that was seen but not included in this listing is the ratio of retained earnings to net income. This ratio was mentioned only in Troy's book (see page xii). In this ratio, retained earnings does not refer to the cumulative earnings beginning with the inception of the business; instead, retained earnings refers to the current period's earnings which were not distributed. The retained earnings to net income ratio is omitted from this listing because the ratio is not prepared from any balance sheet component of owners' equity.

Components of Owners' Equity Used in Financial Ratios

In the ratios above, there are some in which owners' equity may be used in total whereas in others, owners' equity must be subdivided. The ratios in which owners' equity must be divided are discussed.

Tangible owners' equity. -- As was noted, some analysts prefer to use tangible owners' equity instead of total owners' equity. To calculate the tangible owners' equity, the value of the intangible assets must be deducted from the total owners' equity.

Several reasons have been cited by writers for using only tangible net worth. One reason is that the intangibles may have little or no value in forced liquidation. From the creditors' viewpoint, intangibles may not provide any buffer or margin of safety. A second reason is that the policies of companies for valuing intangibles vary so widely. To achieve comparability between the companies, a practical solution is to disregard any values assigned to the intangible assets. A third reason for disregarding intangibles is that intangible assets are not valued


properly. The reasoning is that the real value of intangible assets lies in their income producing ability. The intangible assets, however, are usually reported on the balance sheet at cost less amortization. Because accounting does not report the intangible assets on the basis of their income potential, some analysts say the amount reported on the balance sheet is unsatisfactory. The analysts often remove the intangible asset values because they do not convey any usable information.\(^7\)

On the other hand, some analysts would not deduct the intangible assets from the total owners' equity. Their argument is that there is no reason for treating intangible assets any differently than tangible assets. Property, plant, and equipment, for example, are accounted for at cost less amortization, and their net book values do not necessarily represent future earnings, either.\(^8\)

Although there is no clear-cut solution to the issue, the division of owners' equity into tangible and intangible parts is frequently used in financial and investment analysis.


\(^8\)Hendriksen, Accounting Theory, p. 340.
Owners' equity allocated among several classes of stock.--If there are two or more classes of stock, a few of the financial ratios require that the owners' equity be allocated among the various classes. Ratios or statistics in which owners' equity must be subdivided according to classes are (1) the percentages of preferred and common stock to total capital, (2) the rate of return on common stock equity, and (3) the book value of common stock.

The other ratios and calculations on pages 107 and 108 do not require any allocation to classes of stock. For instance, all the capital structure ratios with the exception of the percentages of common equity and preferred equity to total capital are measures of safety to the creditors. As far as the creditors are concerned, the equities of both the preferred and common stock are buffers. Because the entire owners' equity provides a buffer for the creditors, there is usually no need to differentiate between the equities for each class of stock in preparing the capital structure ratios.

The fixed asset ratios involving owners' equity are also measurements of the margin of safety to the creditors. The fixed asset ratios may suggest whether there is an under- or overinvestment of capital by the owners of the firm.9 The ratios may also indicate if the firm has

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9Welsch, Zlatkovich, and White, op. cit., p. 888.
borrowed too heavily.\textsuperscript{10} For the same reason as in the capital structure ratios, there is no need to differentiate the margin of safety in the fixed asset ratios between the common and preferred stock equities.

The ratio of net sales to owners' equity measures the activity of the owners' investment. Increases in the ratio mean that the owners' equity is being used more skillfully and efficiently. However, a very high ratio may indicate that the firm is undercapitalized and that there is an overuse of borrowed capital.\textsuperscript{11} In this ratio, there is no need to differentiate between preferred and common stock equities.

In the percentages of net income to total owners' equity and to total capital, the owners' equity does not need to be separated into its common and preferred stock equities. The entire amount of owners' equity is used in the denominator of both computations. In determining the asset protection per bond, the entire owners' equity is part of the protection given to each bond. The asset protection of preferred stock also includes the entire owners' equity. The distinction between the common stock equity

\begin{footnotesize}

\end{footnotesize}
and the preferred stock equity is not necessary in any of these ratios.

As was noted, there are only four ratios or statistics in which an allocation of owners' equity needs to be made between the several classes of stock. However, the major problem is in determining the basis on which the allocation should be made. This problem is taken up later in the chapter.

Capital and surplus.—The only other ratio that requires any classification of owners' equity into separate parts is the ratio of surplus to capital stock. This ratio was mentioned in only one of the nineteen sources which were reviewed.\(^\text{12}\) The purpose of this ratio is to convey the conservatism of management. A large ratio of surplus to capital is supposed to indicate a conservative management.

Guthmann, in whose book this ratio is discussed, seems to discredit the ratio. He lists three objections, all of which can cause misinterpretation of the ratio. One objection is that surplus can arise from so many sources besides earnings that the ratio may not be a good indicator of earnings' retention. The ratio may also be misleading when there have been stock dividends; amounts actually

retained in the enterprise no longer appear in surplus but instead are added to the capital portion of the ratio. A third criticism is that the age of the company also plays a large factor in the ratio.\textsuperscript{13} In general, this ratio's usefulness is questionable.

**The Allocation of Owners' Equity to the Classes of Stock**

As was discussed earlier in the chapter, there are four ratios or calculations which require that owners' equity be allocated to the preferred stock equity and the common stock equity. These four calculations are the book value per share of common stock, the rate of return on common stock equity, the percentage of preferred stock equity to total capital, and the percentage of common stock equity to total capital. There are several bases which could be used for allocating owners' equity to each class of stock. However, there is not much agreement among financial or investment analysts as to how owners' equity should be allocated.

**Book value per share.**—In the calculation of book value per share, financial and investment analysts advocate a diversity of methods for assigning equity to preferred stock. Badger, Torgerson, and Guthmann recommend using the

\textsuperscript{13}Ibid.
par value of preferred stock. Meigs, Johnson, Keller and Mosich say that the call price is the value which should be assigned to preferred stock. Graham, Dodd, and Cottle maintain that preferred stock should be assigned an amount equal to the highest of par value, call price, market value, or a synthetic value. (The synthetic value is the amount of the preferred dividend capitalized at an appropriate rate. The synthetic value of a preferred stock with a dividend of $4 capitalized at 5% is $80.) Finney and Miller; Welsch, Zlatkovich, and White; Kennedy and McMullen; and Prime all endorse the liquidation value as being the proper measure for preferred stock. Hayes and Guthmann also would use the liquidation value if the preferred stock


15 Meigs and others, op. cit., p. 585.


is no-par stock or if the par value is nominal.  

Guthmann advocates the use of par value in most instances because it represents the going-concern concept. He says that the call price and liquidation values should be ignored because they are not based upon the principle of the going concern. Meigs and others suggest the call price because it is more significant than the liquidating values; however, they do not say why the call price is preferable to the par value from a going-concern viewpoint. Those who recommend the highest of par value, call price, or market price do not state any reason why this method provides the best value to be assigned to preferred stock. And those who advocate that liquidation values be used think that the book value should be a liquidation concept.

The justifications just cited reflect two fundamental concepts. One is that the book value should reflect
the going-concern concept. The second justification is that book value should be a liquidation concept. To determine which of the two has the most merit, the manner in which financial analysts define and use book value is examined.

Writers on financial analysis first assert that the book value of stock is not a guide to its market value. The book value measures the paid-in capital and retained earnings of the owners in the firm while market value reflects the estimates of the firm's prospective earnings. The book and market values measure two different things, and there is no reason for the two to be similar in value.

According to several writers, there is an indirect relationship between book value and market value. These writers stress that the trend of the changes in the book value is important and may have some effect on the market price. Whenever an enterprise retains some of its earnings, the book value or capital base which management has to work with is larger. If management can continue to earn the same rate of return on a larger book value, the earnings per share would increase. In turn, the market value should increase because of the larger earnings.23 In their discussions, however, none of the writers mention preferred

stock and the concept of book value which might be most useful in studying the relationship of changes in book value and future earnings.

The most prevalent concept of book value seems to be a liquidation concept. Book value is most commonly defined as the amount each share of stock would receive if the company were liquidated and its assets were sold at their book value. But as most writers quickly acknowledge, the probability that the assets could be sold at their book value is highly unlikely; in forced liquidation, the assets seldom have as much value as is shown in the accounting records. The *Accountants' Handbook* describes this concept of book value as being "essentially a liquidation concept based on going-concern values." For this reason, the book value per share has only limited significance.

A few writers have indicated that book value per share should represent a going-concern basis. However, none of these writers elaborated on this point. Obviously, preferred stock would not be valued at liquidation values,

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but there is not any clear idea as to what is meant by a going-concern valuation of preferred stock. As was noted earlier, one writer stated that par value is in accordance with the going-concern concept while another said that the call price is appropriate for a going-concern valuation.26

In general, analysts have little use for the book value per share. Authors give little attention to the interpretation and significance of book value per share as compared to some of the other financial ratios and calculations. Some writers even downgrade book value. Myer says that book value per share has been assigned undue importance.27 Graham, Dodd, and Cottle state that analysts make very little use of book value per share.28 Several practicing investment analysts have also pointed out the low esteem of book value per share.29 And some authoritative literature on financial analysis does not mention book value per share.30

The use which is made of book value per share is not clear and does not offer much help in resolving how the

26 Supra, p. 116.
27 Myer, Financial Statement Analysis, p. 269.
28 Graham, Dodd, and Cottle, Security Analysis, p. 216.
29 Bridwell, op. cit., p. 9; Block, op. cit., p. 29.
preferred stock should be valued. However, the liquidation concept of book value per share seems to be the most generally accepted notion.

**Rate of return on common stock equity.**—In computing the rate of return on common stock equity, the equity of the common stock must be ascertained whenever there are two or more classes of stock outstanding. Of the nineteen reference books on financial ratios that were reviewed, only one was specific about how owners' equity should be assigned to preferred stock in the computation of the rate of return. The one source, Finney and Miller, indicated that the value of preferred stock should be its liquidating value.\(^{31}\) Whether the other writers also intended for the liquidation value to be assigned to the preferred stock was not discussed in their books. In conclusion, there is not much evidence of what principle is used by financial analysts to allocate owners' equity among two classes of stock when computing the rate of return on common stock.

**Percentages of common and preferred equity to total capital.**—There is also an absence of information on how owners' equity should be allocated when computing the percentages that the preferred and common stock equities are

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to total capital. These percentages are generally used for studying the margin of safety of creditors. Although analysts are silent about this point, liquidation values would seem to be appropriate for determining the margins of safety.

Rate of Return on Common Stock Equity

In the majority of instances, the difference between par, liquidation, and call values is so slight that the rate of return on common stock equity is not affected materially. However, there are some cases in which the par and liquidation values are significantly different, and the question as to what types of value should be used does become important.

When the liquidation and par values are used to allocate owners' equity to the several classes of stock, the rate of return on common stock equity is sometimes distorted. Two examples of this are discussed.

Misleading effect of par value.--The first example illustrates a distortion which may result when allocating owners' equity to preferred stock on the basis of its par value. The rate of return on common stock shows a decline whereas the profits on common stock have actually improved.

Assume a hypothetical firm which has a common stock equity of $20,000. The firm has been earning $1,600 annually for a rate of return of 8 per cent.
The business enterprise decides to issue one hundred shares of preferred stock with a par value of $500. The preferred stock has a dividend rate of $6 per share, and the stock is issued for $10,000. In the first year that the preferred stock is outstanding, the new investment adds $1,000 to the earnings. The total income is now $2,600. After deducting the preferred stock dividends, the earnings for common stock are $2,000.

If only the par value is assigned to preferred stock, the equity of common stock is $29,500. This consists of the $20,000 original common equity and $9,500 of the amount paid in by preferred stockholders in excess of par value. The earnings of $2,000 result in a rate of return on common stock of 6.8 per cent. The rate of return has fallen from the 8 per cent earned in the prior period.

In the illustration, the common stockholders did not invest any additional capital while their profits increased by $400. This favorable increase took place because the firm was able to generate earnings of 10 per cent on the new capital. Leverage was used successfully, the earnings on the new capital exceeding the preferred stock dividends. There is no doubt that the earnings of the common stockholders are improved in the second year. However, the rate of return on common stock indicates that the earnings' performance has declined. In this situation, the rate of return is misleading.
Misleading effect of liquidation value.—Using liquidation values to allocate owners' equity to the preferred stock can also be distorting. Using the preceding hypothetical business enterprise, the effect of liquidation values on common stock equity is examined.

Assume that the liquidation value of the preferred stock in the hypothetical firm is $14,000. This leaves $16,000 for the common stockholders' equity. The earnings on the common stock equity are $2,000, and the resulting rate of return on common stock equity is 12 1/2 percent. However, assume that all the facts above are the same except that the liquidation value had been set at $25,000 rather than $14,000. In such a case, the rate of return on common stock would be 40 percent.

The effect is that the higher the liquidation value, all other things being equal, the higher is the rate of return. The earnings for the common stock are the same regardless of the liquidation value. However, the increased liquidation value results in a smaller base for computing the rate of return and is the cause of the higher earnings' rate.

Arbitrary valuation on preferred stock.—The amount of the par value can similarly influence the rate of return. A high par value assigns a large part of owners' equity to preferred stock. This results in a smaller common stock
equity which produces a higher rate of return on a given amount of earnings.

The weakness is that the liquidation and par values can be arbitrarily established when the preferred stock contract is being written. The two values do not have to be related to any economic fact or event.

The measurement of management's effectiveness is seriously impaired when the capital base is influenced by arbitrary values. An opportunity is also provided for an enterprise to manipulate or influence the level of its earnings' rate. A rate of return prepared in this manner can also be misleading when compared to the rate of return on common stock of other companies.

Valuation based upon paid-in capital of preferred stockholders.--The owners' equity could be assigned to preferred stock on the basis of the assets supplied by the preferred shareholders. This method removes the arbitrary assignment of a valuation. The method should also give a more reliable rate of return on common stock.

This method of allocating owners' equity would correct the rate of return of the enterprise that shows a decreasing rate of return when the earnings' situation is improving. In the illustration that was discussed earlier, none of the preferred stockholders' capital

\[ ^{32}\text{Supra, pp. 121-22.} \]
The contribution would be allocated to the common stock equity. The earnings of $2,000 on the common stock equity of $20,000 would give a 10 per cent rate of return on common equity. The increase from 8 per cent of the previous year is consistent with the higher earnings on the common stock without investing any new capital.

Rates of return illustrated for Glen Alden Corporation.--The hypothetical examples that have been discussed are not unrealistic. The Glen Alden Corporation parallels the examples in several ways.

In 1967, Glen Alden Corporation acquired several firms by exchanging Glen Alden preferred stock for the equities in the acquired firms. These acquisitions were treated as poolings of interests. The poolings added at least $132 million of equities to the net worth of Glen Alden. On December 31, 1967, the total owners' equity was $216 million. On the same date, the stated value of the preferred stock was $51 million. The liquidation value of preferred stock was $346 million.

The liquidation value of Glen Alden's preferred stock exceeds the firm's total net worth. Obviously, the rate of return on a negative common stock equity is

33 Appendix II contains a summary of pertinent financial data taken from the annual reports of the Glen Alden Corporation. Appendix II also shows the computation of all the ratios of Glen Alden that are discussed in this section.
meaningless.

However, assume that the liquidation value of the preferred stock had been $210 million rather than the actual $346 million. For 1967, the rate of return would have been 120 per cent on the common stock. (The earnings on the common stock were $7.2 million. The common stock equity would have been $6 million based upon the assumed liquidation value.) Compared to the 9.1 per cent rate of return on common stock which Glen Alden earned in the year prior to the poolings, the poolings have enhanced the earning power of the common shareholders.

If the rate of return were computed by allocating only the stated value to the preferred stockholders' equity, the rate of return would be 4.4 per cent. Compared to the 9.1 per cent earned prior to the poolings, the earnings' rate has declined by more than 50 per cent.

The rate of return would be 8.6 per cent if the preferred stock equity were based upon the capital supplied by the preferred stockholders. This rate of return shows that the earnings' effectiveness of the common stock declined only a small amount after the poolings.

_Evaluation._--The rates of return based upon liquidation, stated, and contributed values give three contradictory notions about the success of the poolings from the viewpoint of the common stockholders. In this two-year
period, the profits of common stockholders went up from $6.4 million to $7.2 million. This was an increase of 12 1/2 per cent. However, there were additional investments of common stock equity. The investments increased the common stock equity by 20 per cent. The effect was to decrease the earnings per share from $1.35 in 1966 to $1.31 in 1967.

The figures in the preceding paragraph do not support the idea that the earnings' effectiveness increased from 9.1 per cent to 120 per cent. Nor do they seem to indicate that the earning power on common stock has fallen by 50 per cent. The rate of return based upon the capital contributed by each class of stock seems to correspond closely with the data in the preceding paragraph.

The Use of Traditional Components of Owners' Equity in Ratio Analysis

As has been seen, there are not many ways in which owners' equity needs to be divided or classified to meet the needs of ratio analysis. Most of the ratios use either total owners' equity or tangible net worth. A few ratios do require that owners' equity be allocated to the several classes of stock.

At least two writings in investment analysis literature have commented specifically about the classification of owners' equity for ratio analysis. In discussing the rearrangement of financial data for ratio analysis, Sauvain
says that owners' equity needs to be classified according to each class of stock. In addition, he states that the various surplus accounts (including both earned and capital surplus) should be

... combined into one amount because the analyst is seldom interested in the source of surplus. In fact, total surplus is often combined with common stock into one item called "common stock and surplus," or "common stockholders' equity."34

Graham and McGorlick would also combine the accounts. They say:

... the division between capital and surplus may be quite meaningless. For most purposes of analysis it is best to take the capital and the various kinds of surplus items together, giving a simple total equity of the stockholders.35

The Role of Owners' Equity in Predicting Dividends

Many stockholders are interested in the current and future dividends which a business enterprise may pay. Obviously, those investors who purchase stock for current income purposes are interested in the dividend prospects. Even those stockholders who do not invest primarily for current income purposes may be interested in the future dividend payments, for dividends may influence the investor's valuation of the stock.36

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34Sauvain, Investment Management, p. 201.
36Hayes, Investments, p. 313.
Factors Generally Considered in Estimating Dividends

In studying the prospect of future dividends, most financial and investment analysts stress the importance of the firm's dividend policy. Some firms have a relatively stable pay-out ratio while others tend to pay a rather constant amount of dividends each year. When a firm does have a stable dividend policy of one kind or another, the future dividends can be estimated with a higher degree of confidence than when there is no apparent policy. In addition, other factors must also be weighed by the analyst. Other factors include the legal availability of surplus, the stability of earnings, the condition of working capital, special plans for expansion or contraction of the business, and the temperament of the corporation's directors.\(^{37}\)

The owners' equity section of the balance sheet provides relatively little information that is helpful for predicting prospective dividends. For instance, the owners' equity section does not reveal anything about the firm's dividend policy. Instead, the dividend policy must be ascertained by studying past years' dividends and comparing them with the earnings. Neither does anything in the net worth section provide information about the stability of earnings, the condition of working capital, or any future

changes in operations. The only information owners' equity can provide is the maximum legal amount of dividends that can be declared.

**Unrestricted Owners' Equity**

The legal amount of owners' equity which is used as a basis for declaring dividends must be determined in accordance with state corporate statutes. In this study, the term "unrestricted owners' equity" is used to refer to the equity on which dividends may legally be paid. This term is chosen because the terms "earned surplus" and "surplus" are too narrow. In a few states, dividends can be "paid" only from earned surplus; in other states, dividends can be "paid" from capital surplus as well as earned surplus; and in some states, dividends can be "paid" from stated capital if there are current earnings but no surplus. "Owners' equity" is broad enough to include all components from which dividends might be declared. However, the term "unrestricted" is necessary to indicate what amounts of owners' equity are legally available for dividend purposes.

Whether or not unrestricted owners' equity influences dividends depends upon each situation. In many situations, the unrestricted owners' equity has no restraining influence on the amount of dividends that a company is likely to pay. This is true especially in those instances in which the unrestricted owners' equity is large compared to
the firm's liquidity position and ability to pay a dividend. In these cases, there is a large difference between what the company financially can and wants to pay and what it is legally able to pay.

In other cases, the unrestricted owners' equity threatens to limit the dividends that would otherwise be declared. In this situation, the unrestricted owners' equity probably becomes an important factor to the investor or analyst. But even here, the unrestricted owners' equity does not give any indication as to how much of the unrestricted amount will be paid.

Retained Earnings as an Indicator of Success

Retained Earnings and Past Success

The size of a firm's retained earnings is not a reliable indicator of past profits or success. The retained earnings' balance is the net result of past profits, dividends, losses, and earnings that have been capitalized. To judge the past profits on the basis of this cumulative balance is erroneous, especially because it is the combination of several factors. A large balance of retained earnings does indicate that a firm has earned a large profit in the past. But on the other hand, a small balance does not necessarily signify that a company has been unprofitable. An extremely profitable business may have a small retained
earnings' balance if a large proportion of the earnings have been capitalized or distributed as dividends.

The retained earnings' figure is also influenced by the length of time the firm has been in operation. The older the firm, the better the chance it has had to build up the size of its retained earnings. By comparison, a young but successful enterprise has not had as much opportunity to accumulate a large amount of retained earnings.

**Deficits and Unsuccessful Operations**

A deficit in retained earnings does mean that a business firm has had some net losses in its past. However, financial analysts do not seem to say whether or not they regard a deficit as a sign of weakness or probable failure.

A deficit would seem to be a poor indicator for determining the extent of a firm's unsuccessful past operations. A deficit often is the arithmetic result of several factors. To attribute a deficit entirely to net losses is erroneous. Two businesses could have identical profits and losses, but one firm may have a deficit while the other has a positive balance in retained earnings. The firm with a deficit may have capitalized a large portion of its earnings. Therefore, when an operating loss is incurred, there may not be enough retained earnings to absorb the loss.

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Consequently, the firm has a deficit. The other firm may still have a positive balance in retained earnings because it has not capitalized any earnings and still has an adequate balance to absorb any losses. The presence of a deficit should not necessarily mean that one firm is worse off than another which has a positive balance of retained earnings. Just as retained earnings is not a good index of successful operations, a deficit is not a proper index of business failure.

The best indicator of an enterprise's success or failure is its income statement. The income statement reports the results of past operations more clearly than the retained earnings and is not affected by dividends and other reductions.

Appraisal Capital in the Analysis of Financial Statements

Roy Foulke insists that appraisal capital should be shown as a separate item in the owners' equity section. According to Foulke, this is an important fact, and it should be clearly stated. In his opinion, the owners' equity accounts are grossly misleading if the statement reader is not notified of such a valuation. However, he does not indicate any specific use of appraisal capital in

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39 Foulke, Practical Financial Statement Analysis, pp. 585-86.
financial analysis.

On the other hand, Birnberg questions the usefulness of appraisal capital to the statement readers. Birnberg does not visualize any situations in which the amount of appraisal capital is a relevant piece of information or would affect an investor's decision.  

Other writers have not commented on the role of appraisal capital and its treatment in financial analysis. However, upward revaluations of assets are rare and are seldom encountered by analysts or investors.

**Provisions on Owners' Equity for the Protection of Creditors and Preferred Stockholders**

In evaluating their investments, creditors and preferred stockholders are interested in the restrictive provisions on owners' equity. The provisions can either add to or detract from the margin of safety of these two investor groups.

**Dividend Restrictions as a Protection for Creditors**

The most common protective provision that affects owners' equity is the restriction on the distribution of assets to the stockholders. The larger the restrictions,  

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40 Jacob G. Birnberg, "An Information Oriented Approach to the Presentation of Common Stockholders' Equity," The Accounting Review, XXXIX (October, 1964), 970.
the larger is the buffer or margin of safety that is afforded to the creditors. In evaluating the margin of safety, the creditors need to know the amount of owners' equity that is either restricted for distribution purposes or else is available for dividends.

As is obvious, the creditors and stockholders are interested in the same information for two different purposes. The owners' equity that serves as a protection for the creditors is not legally available to the stockholders for dividend purposes. On the other hand, any net worth which is legally available for dividends does not afford the high degree of protection for the creditors.

**Protective Provisions for Preferred Stockholders**

The preferred stockholders may also have certain protective provisions that affect owners' equity. The right of preferred stockholders to receive dividends ahead of common stockholders is a protective device afforded the preferred shareholders. The right is further strengthened by the cumulative feature. The preferred right to assets during liquidation also strengthens the safety of the principal of the preferred stockholders. And restrictions on the withdrawals of assets by common stockholders serve as a buffer for the preferred stock as well as for the creditors. The preferred stockholders use this information about owners' equity in evaluating the safety of their
Implication for Classifying Owners' Equity

The discussion in this chapter has shown that there is a variety of information which statement readers want to know about owners' equity. With an abundance of useful data to be communicated, there is little reason for using any classification basis which fails to disclose the facts that statement readers can use.

Throughout this chapter, one could see that the various classification methods described in Chapter III provide much of the information needed by statement readers. This topic is explored more fully in the following chapter.

Summary

Statement readers want information about owners' equity for three different reasons. One is for the computation of financial ratios. A second is to determine whether dividend payments might be hindered by legal restrictions. And a third is in the evaluation of the protection given to the creditors and preferred stockholders.

In ratio analysis, most ratios involving an owners' equity item use either total owners' equity or tangible owners' equity. There is no need for the owners' equity to

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be differentiated into components such as invested capital, earned surplus, or capital surplus. In most ratios, the total owners' equity figure is sufficient.

When there are two or more classes of stock, owners' equity must be allocated to each class in the computation of certain ratios. One such instance is the computation of the book value per share of common stock. In this computation, preferred stock is usually valued at its liquidation value; any residual is the equity of common stock. In computing the rate of return on common stock, the value of the capital contributed by the preferred stockholders should be allocated to the preferred stock equity.

Unrestricted owners' equity indicates the maximum legal amount of dividends which can be paid. This figure is of importance if it restricts the amount of dividends which would otherwise be paid. In many situations, unrestricted owners' equity is so large compared to the usual dividend payments that the unrestricted amount is not a hindrance. Normally, unrestricted owners' equity is of little use in estimating prospective dividends.

Creditors and preferred stockholders want to know the restrictions on owners' equity. The restrictions are important because they add to the margin of safety of the creditors.

The owners' equity section does not provide any useful information in studying future earnings. Neither is
retained earnings a satisfactory index of past profitability.

The information which analysts, investors, and creditors want to know about owners' equity is:

1. total owners' equity
2. tangible owners' equity
3. liquidation value of preferred stock
4. capital paid in by preferred stockholders
5. amount of unrestricted owners' equity
6. the restrictions on owners' equity
7. the par value and call price of preferred stock (although par value has only questionable use).
CHAPTER V

EVALUATION OF THE CLASSIFICATION BASES
FOR REPORTING OWNERS' EQUITY
ON THE BALANCE SHEET

The previous chapters include discussions of the nature of owners' equity, the needs of the financial statement readers, and some of the several ways in which owners' equity can be classified. These topics have provided a background useful in evaluating how the owners' equity should be classified on the balance sheet.

The present chapter includes evaluations of the classification bases as to their suitability for financial reporting. As was noted about the theory of classification, there are numerous ways of classifying data, but not all of them have equal value. Some classification methods are more useful than others. In evaluating the suitability of the methods of presenting owners' equity, usefulness of the data is the primary criterion.

Each of the classification methods is analyzed as to its usefulness from the statement readers' point of view. Some of the classification bases may be rejected as having little value while others may be found to present information which is useful to investors, creditors, and analysts.
Source Method of Classification

Justifications for the Source Basis

The source basis has been recommended by many accountants as the best method for reporting owners' equity. Numerous reasons have been advanced to justify this position. A summary of the reasons cited in the literature is given below.

Disclosure of economic facts.--One justification for the source basis is that it is consistent with the general purpose and nature of the balance sheet. In this argument, proponents say that the purpose of financial statements is to communicate data of an economic and financial nature. Based upon the foregoing premise, the legal basis of classification is rejected because it can obscure the underlying economic facts. In contrast, the source basis is favored because the sources of owners' equity do represent economic facts.¹

Generally, the above argument unwittingly limits the classification of owners' equity to two alternative methods, the sources and the legal components of owners' equity. Obviously, one of the weaknesses is that it overlooks the possibility that other classification bases may also

¹Paton and Littleton, Corporate Accounting Standards, pp. 105-106; Broad, "Is It Desirable to Distinguish between Various Kinds of Surplus?," pp. 281-82.
reflect economic facts about owners' equity.

Paton and Littleton also feel that the distinction between invested and earned capital is appropriate for financial administration functions. They discount the usefulness of the legal concept of capital for financial purposes when they write:

... Business needs are not adequately served if terminology and organization of the statements are too strongly influenced by the legal concepts and considerations.²

They conclude that

... the managerial and financial uses of corporate statements are more frequent than the strictly legal uses, and the customary usage should control the form of presentation rather than incidental usage.³

Consistency with the nature of the balance sheet.--

Another justification based upon the nature of the balance sheet is presented by Lowe. Lowe points out that the balance sheet is a report about (1) the assets which have been entrusted to the corporation and (2) the suppliers or sources of the assets. In reporting on the sources, each source should be clearly identified. To be consistent with this principle, Lowe contends that the presentation of owners' equity should emphasize each one of its sources.⁴

Importance of the distinction between paid-in and earned capital.--Other writers stress the reasons why the distinction between invested capital and retained earnings is significant information. For one thing, invested capital is the base from which all incomes, gains, and losses are measured. Furthermore, invested capital is the focal point for determining the commitment of owners' capital. The invested capital is permanently committed to the firm until its termination. Any owners' equity in excess of the invested amount does not have the same degree of commitment.5

Stockholders are also presumed to be interested in the distinction between invested capital and retained earnings when dividends are received. Stockholders usually presume that dividends represent distributions of earnings. If the distributions are not from earnings, stockholders should be aware of the exception. The sources of owners' equity must be maintained so that the exact nature of distributions to stockholders can be known.

Other writers contend that the historical development of owners' equity as indicated by its sources is important. Hendriksen says that

... Corporate growth provided through internal sources of funds is relevant information when compared with a firm that has grown entirely through the sale of

preferred and common stock or through the sale of debentures.\textsuperscript{6}

And some writers say that sources of owners' equity provide an insight about a firm's profitability. Dohr states that retained earnings is "a representation as to the profitability of the business enterprise."\textsuperscript{7} Paton and Littleton write:

\ldots with reference to the measurement of earning power, [earned] surplus should preferably not be fused with paid-in capital either by transferring [earned] surplus to capital account or vice versa.\textsuperscript{8}

The sources of owners' equity are acknowledged in the Accounting Terminology Bulletins as an important standard to be considered in reporting owners' equity.\textsuperscript{9} However, in prescribing the accounting procedures for stock dividends and other transfers of retained earnings to paid-in capital, the Accounting Terminology Bulletins follow the legal rather than the source basis.\textsuperscript{10}

\textsuperscript{6}Hendriksen, \textit{Accounting Theory}, p. 405.
\textsuperscript{7}Dohr, "Capital and Surplus in the Corporate Balance Sheet," p. 40.
\textsuperscript{8}Paton and Littleton, \textit{op. cit.}, p. 105.
\textsuperscript{9}Committee on Terminology, \textit{Accounting Terminology Bulletins}, pp. 29-30.
\textsuperscript{10}\textit{Ibid.}, pp. 30-31.
Sources and Their Usefulness to Statement Readers

The previous section enumerated the merits which various accountants have attributed to the source basis of classification. However, there are numerous objections to some of the reasons. In this section, some of the objections are mentioned and the arguments favoring the source classification are evaluated.

A summary of the justifications for the source basis of classification are:

1. The right-hand side of the balance sheet represents the sources of assets. Presentation of the sources of owners' equity is consistent with the overall principle.

2. The balance sheet is used more frequently for making decisions of a financial nature than of a legal type. The source basis would therefore be more useful than the legal classification of owners' equity.

3. Invested capital and retained earnings represent a distinction between capital which must be permanently retained and that which could be available for distribution. This information is useful to creditors and investors alike.

4. The source basis is necessary so that stockholders know whether dividends are distributions of earnings or of capital.
5. Retained earnings is helpful in studying the growth and profitability of the firm.

The first justification does not specify any way in which statement readers use information about owners' equity. However, the second justification does recognize that the use of the data should be a governing factor of classification. The last three reasons identify specific uses of information about the sources of owners' equity.

The forementioned justifications are discussed below.

Sources of the firm's assets.--As was developed in Chapter II, the right side of the balance sheet represents the sources of assets. The issue is then whether every subclassification of liabilities and owners' equity must be by sources. According to classification theory, the ideal method is to use the same principle throughout all levels or stages of classification. From a practical point of view, however, theorists recognize that adherence to the same classification principle through all stages may not provide meaningful information. Consequently, changing the principle of classification from one stage to another is acceptable if the usefulness of the data is improved.

Classifying owners' equity by a method other than source does not negate the concept that owners' equity

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represents a source of the enterprise's capital. For instance, classification of owners' equity by its utilization tells how the capital provided by the owners is being used. Or the legal classification indicates the legal status of the capital provided by the owners. The manner in which owners' equity is subdivided does not obscure the amount of capital that has been provided by the stockholders.\textsuperscript{12}

The source method of classifying owners' equity cannot be wholly justified merely because the right-hand side of the balance sheet represents the sources of capital. More important is whether the sources of owners' equity provide useful information to the readers of financial statements.

\textbf{Owners' equity available for distribution.--}Some persons state that the source basis indicates the amount of owners' equity which may be withdrawn. The invested capital is regarded as a permanent investment whereas the retained earnings is not so regarded. However, this premise is only an ethical or moral point of view and does not always correspond to the legal statutes. Creditors, for instance, should be aware that some invested capital can be distributed to the stockholders under certain circumstances.

\textsuperscript{12}In this paragraph, "capital provided by stockholders" is used in the sense that retained earnings is part of the capital provided by stockholders. See pp. 42-43.
And on the other hand, some retained earnings cannot be distributed because it has become part of the stated capital. In determining what part of owners' equity is distributable, the legal classification is more pertinent than the sources of capital; the legal basis is the one which is enforceable and must be observed.

Nor does the retained earnings represent the amount of owners' equity that is not permanently committed. As Mason notes, retained earnings can be tied up in long-term assets and not be available for distribution. Obviously, many corporations today consider most of their retained earnings to be a permanent method of financing. Using the sources of owners' equity to interpret the permanent commitment of owners' capital is erroneous.

Source of dividend payments.—Advocates of the source basis assume that shareholders want to know if a dividend represents a distribution of paid-in capital or of earnings. If the dividend represents a distribution of earnings, stockholders have an income. If the dividend represents a distribution of capital, stockholders do not have any income. This concept is generally used in accounting, law, and federal income taxation.

However, the concept is open to question, especially

as it applies to stockholders who are not the original owners of stock. Subsequent owners usually pay a price for the stock which does not correspond to the amount of capital that the corporation received when the stock was originally issued. In effect, the new owner is acquiring the book value of stock which includes both a paid-in amount and retained earnings per share. If the corporation declares a dividend soon after a new stockholder acquires a share from a prior owner, the dividend in a sense does not represent income to the new stockholder; instead, the dividend merely represents a distribution of retained earnings which the investor has already purchased. Or if subsequent dividends received by the stockholder exceed the earnings during the time he holds the stock, part of the dividends represent, in effect, a return of capital. In conclusion, a distribution of corporate retained earnings does not provide a sufficient basis for the investor to presume that the dividend is income to him. Each investor must assess for himself in his own situation whether a dividend is income or a return of capital.\(^\text{14}\)

The above situation is recognized in several instances. One is by parent corporations which account for their subsidiaries on the cost basis. If the subsidiary

pays a dividend based upon retained earnings created prior to the parent's acquisition of the subsidiary, the parent regards the dividend as a recovery of capital, not income. Another such recognition of the inadequacy of paid-in capital and retained earnings is whenever a corporation liquidates. The stockholder disregards the amount of paid-in capital and retained earnings which the corporation says are being distributed. Instead, the stockholder first applies the proceeds against his own cost of the investment. Any excess of proceeds over cost is income to the shareholder.\footnote{15}

The stockholder needs some method to judge whether a dividend represents income to him or not. Reliance upon the corporation's viewpoint of what the dividend represents is unsatisfactory from the investor's point of view. One suggested procedure is to use the accrual or equity method of accounting for investments.\footnote{17} The investor's income would be equal to his share of corporate profits earned


\footnotetext{16}{Wixon, \textit{op. cit.}, p. 13-17.}

\footnotetext{17}{Gabriel A. D. Preinreich, \textit{The Nature of Dividends} (Lancaster, Pa.: Lancaster Press, Inc., 1935), pp. 31-33, 47-50.}
during the time he holds the stock. Dividends would not affect the amount of the investor's income. If the earnings exceed the dividends during the time the stock is held, the dividends represent a distribution of earnings. However, if the dividends exceed the earnings, the excess represents a distribution of capital from the investor's point of view. In a slight variation, George May suggests that from the investor's viewpoint, income should not exceed either the (1) income accrued during the time of the investor's ownership or (2) the amount of dividends received by the investor.\(^{18}\)

The evidence indicates that the source basis of owners' equity is not pertinent in determining whether the shareholder has earned an income on his investment. A distribution of earnings by the corporation is not necessarily income to the investor. The investor must use other methods to ascertain if the dividends are returns of capital or distributions of profits.

**Earning power and sources of owners' equity.**--Several writers have expressed the idea that retained earnings is a meaningful figure in studying the development and profitability of owners' equity. The development of the firm is

disclosed in that the sources do show how much of the owners' equity has been provided by internal growth. But as was discussed in the previous chapter, the size of retained earnings is not a reliable indicator of past or future profitability.\(^\text{19}\)

**Evaluation**

The pros and cons of the source basis have been discussed at various places in this study, and an overall evaluation needs to be made.

**Tracing the owners' equity to its sources.**--As was noted in Chapter III, the source basis of classification is predicated upon a system of generally accepted assumptions.\(^\text{20}\) The assumptions are necessary because there is no way to relate decreases of owners' equity to specific sources. However, the use of unprovable assumptions lessens the authenticity of the amount of owners' equity attributable to each source.

Even if the assumptions are accepted, the meaningfulness of the information is questionable. A Committee on Concepts and Standards of the American Accounting Association felt that

\(^{19}\)Supra, pp. 131-33.

\(^{20}\)Supra, pp. 68-74.
the distinction between paid-in capital and retained income may be essentially formal, resulting from the selection of one or the other of two alternatives at the discretion of management.21

One such example of this is the difference between (1) a stock dividend and (2) a cash dividend issued with a stock right.22 Whenever a cash dividend is returned by the stockholder to the firm in exercising a stock right, the effect is to capitalize part of retained earnings. Retained earnings is reduced for the payment of the dividend, but the paid-in capital is increased when the cash from the dividend is used by the stockholder in exercising his stock right. Likewise, a stock dividend is a method of capitalizing retained earnings which by-passes the procedure of paying out and getting back the cash. In essence, a stock dividend is the same as a cash dividend which the shareholder uses to exercise a stock right. However, the accounting procedures of these two transactions have different results on the source basis. In the case of the cash dividend and exercised stock right, the effect is to transfer retained earnings to paid-in capital. But no such transfer is made for a stock dividend; under the source basis of classification, transfers are not made between sources for stock dividends.

22Ibid.
Usefulness.--Usefulness to the financial statement readers is the paramount criterion for evaluating the source basis. As was noted in the previous chapter, information that statement readers might want about owners' equity is the total owners' equity; the tangible owners' equity; the par and liquidation values and the call price of preferred stock; and the restricted or unrestricted amounts of owners' equity. None of these items involve the sources of owners' equity or require that it be classified according to origins. And as was discussed in this chapter, the sources of owners' equity are not valid for studying the profitability or earning power of the firm, for determining the owners' capital which must be retained by the corporation, or in ascertaining whether a dividend is income to the stockholders.

Conclusion.--In conclusion, the readers of financial statements have very little need, if any, to know the sources of owners' equity. The only possible justification for classifying owners' equity by source is that it is consistent with the concept that the equities side of the balance sheet represents sources of capital. However, there is little value in communicating consistent but useless information. In light of all the evidence, the owners' equity section of the balance sheet should not be classified according to sources.
Classification of Owners' Equity by Classes of Stock

When there are two or more classes of capital stock outstanding, financial statement readers often want a breakdown of owners' equity according to classes of stock. As was seen in the previous chapter, the division is helpful in computing the book value per share, computing the rate of return on common stock, and studying the margin of safety for the preferred stockholders. Financial analysts and investors also want to know the amount that preferred stockholders would receive if the stock were redeemed or if the enterprise were liquidated.

Usefulness of Several Values of Stock

Allocating owners' equity among the various classes of stock appears to be a useful method of classification for the statement readers. The book value generally is based upon liquidation values whereas the rate of return should be computed upon the capital supplied by each class of stockholders. The call price is necessary in knowing the assets that preferred stockholders would receive in case of redemption. Obviously, only one method of allocating owners' equity can be used on the balance sheet. However, the other values of the stocks can be shown parenthetically or as notes to the financial statements.
Choice of a Valuation Method
for Presentation Purposes

The valuation concept deemed to be most important is the one which should be used in presenting the equity of each class on the balance sheet. However, there is not much evidence that any one of these valuation concepts is more important than the others. From one point of view, the liquidation value and call price of preferred stock are highly relevant because they pertain to the future; as far as the preferred stockholders are concerned, the capital which they contributed represents a past event and has no future significance. On the other hand, the capital contributed by the preferred stockholders is a requisite value for computing the common stock equity that is necessary in the rate of return on common stock.

If no valuation method stands out above the others, the nature of the balance sheet could be a consideration in allocating owners' equity. Since the right side of the balance sheet represents sources of capital, the owners' equity section could be allocated on the basis of capital supplied by each group of stockholders.

The method of allocating owners' equity to the classes on the balance sheet may not be too critical if the supplementary information is complete. This would be especially true if the users of financial statements are skilled readers who thoroughly study the balance sheet.
The skilled analyst knows that one valuation concept for preferred and common stock is not appropriate for all purposes. Therefore, the analyst will be looking for several different values of the stock. As long as the several values of preferred and common stock are made available as supplementary data in the financial reports, the choice of the value for formal presentation in the owners' equity section is not critical.

**Improvement in Present Balance Sheets**

One weakness of present financial statements is that the capital contributed by each class of stock cannot usually be determined. The total par value of each class is distinctly shown. However, the capital contributed in excess of par is seldom separated according to classes of stock. Instead, a combined figure is presented, thus making it impossible to determine the amount of capital supplied by each group of shareholders.

**Conclusion**

In conclusion, allocation by classes of stock is a useful method of reporting owners' equity on the balance sheet. This classification basis provides information which is generally beneficial to the readers of the balance sheet. The dilemma is that there are numerous methods of allocating the equity to each class, and the information presented by several methods—liquidation value, call price,
and capital contributed by each class—is useful. However, allocating the capital according to the amount contributed by each class is more compatible than any of the other methods with the overall concept of the balance sheet.

**Utilization Basis of Classification**

**Purpose**

The purpose of the utilization basis of classification is to show how the investment of the owners is being used. This pertains especially to the retained earnings. If the enterprise elects to retain some of the income rather than to pay it as dividends, the enterprise should justify its retention. The use to which retained earnings is being put should be identified in the owners' equity section.  

**Weaknesses**

A committee of the American Accounting Association grappled with this question. They recognized that if managerial policy or intention is to be shown, capital stock as well as retained earnings should be subdivided to show their dedication. However, the committee concluded that


24 McMullen, "Clarifying the Balance Sheet," pp. 163-64.
the equity section of the balance sheet is not a practical vehicle for communicating managerial policy. Instead, such information is best disclosed through descriptive narrative material.\textsuperscript{25}

As was noted in the chapter on classification bases, specific assets cannot be verified as coming from the creditors' or owners' equity. Therefore, classification by utilization is dependent upon certain assumptions about the relationships of assets and equities.\textsuperscript{26} Obviously, these assumptions could be challenged. At the present time, there is not any agreement concerning these assumptions.

Conclusion

If there is not general agreement concerning the assumptions, the utilization method of classification should not be used. Confusion could result from the use of a variety of methods that might be reported on the balance sheet. Moreover, all the information for determining the use of owners' equity comes from the balance sheet. If the analyst wants to know how the owners' investment is being used, he can prepare the information himself using the assumptions he believes are correct.

\textsuperscript{25}American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements, p. 21.

\textsuperscript{26}Supra, p. 91.
Legal Basis of Classification

As noted in the previous chapter, investors may be interested in knowing whether the company has any legal surplus for declaring dividends. Creditors, too, are interested in the maximum dividends that can be declared or the amount of capital which must be maintained.

Legal Capital and Consolidated Financial Statements

A problem arises in showing the legal classification of owners' equity on consolidated balance sheets.

Consolidated balance sheets are not considered to be a satisfactory method for reporting the legal aspects of owners' equity. Stated capital and earned surplus apply to individual corporations, not to a group of companies. The earned surplus on the consolidated balance sheet reflects the combined undistributed earnings of the parent corporation and its subsidiaries. To ascertain how much surplus is available for dividend purposes, stockholders of the parent and subsidiary companies should rely upon the balance sheet of their respective corporations.27

To classify the consolidated owners' equity into legal components is both superfluous and misleading.

Strictly speaking, the capital of a non-corporate entity is not subject to any corporate classifications or restrictions. Classifying consolidated owners' equity into par value, earned surplus, and other elements gives the misleading impression that the owners' equity has been legally divided. Moreover, the statement reader is also led to believe that the consolidated retained earnings is the amount on which the parent corporation may declare dividends.

The obvious solution is to omit any legal classification of owners' equity from consolidated balance sheets. However, consolidated financial statements are usually the only financial reports provided to the stockholders of the parent corporation. There is no doubt that the consolidated statements do give a better picture of the overall operations of the parent. But stockholders of the parent do need information about the earned surplus of the parent corporation. If the consolidated statements are the only ones to be provided to the parent's stockholders, consideration should be given to making full disclosure about the earned surplus of the parent. This could be done on the consolidated statements by giving a breakdown of earned surplus in the owners' equity section or by a footnote.

One example showing the details of owners' equity is found in the 1965 annual report of Standard Oil Company (New Jersey). One of the statements shows the changes in
consolidated stockholders' equity during the year. Following the new balance of the owners' equity accounts in the statement is the following data:\textsuperscript{28}

\begin{tabular}{lrrr}
\multicolumn{1}{l}{\textbf{Balance, Dec. 31, 1965}} & \textbf{Capital} & \textbf{Earnings Reinvested and Employed} & \textbf{Total} \\
\hline
\text{Parent company} & $2,262,149$ & $2,759,548$ & $5,021,697$
\text{Affiliates operating in Western Hemisphere} & $3,273,030$ & $3,273,030$
\text{Eastern Hemisphere} & $388,815$ & $388,815$
\hline
$2,262,149$ & $6,421,393$ & $8,683,542$
\end{tabular}

This form of presentation shows the capital and retained earnings of both the parent corporation and the subsidiaries.

\textbf{Usefulness of the Legal Components of Owners' Equity}

\textbf{Importance of the legal components.}—Staubus maintains that the legal classification should be used on the balance sheet. The creditors, he says, are interested in the reliability of the owners' equity as a buffer or cushion. The reliability of the owners' equity buffer depends upon its legal components; some components have higher degrees of reliability than others. Obviously, for instance, stated capital offers a firmer protection than

\textsuperscript{28}Standard Oil Company (New Jersey), \textit{Annual Report}, 1965, p. 17.
the earned surplus. If the legal components are left off the balance sheet, the creditors have no way to judge the margin of safety provided by the owners' equity. 29

Criticisms of the legal components.--However, numerous objections have been made to the use of the legal classification of owners' equity on the balance sheet. As was mentioned earlier, some accountants feel that the financial statements should report economic facts rather than legal facts. Most of those persons favor the source method of classification.

Other accountants believe that the legal aspects are seldom of any importance and that they could be omitted from the balance sheet without any harm. These accountants point out that most major corporations have huge amounts of earned surplus. The earned surplus is so large that future dividends are not affected by the amount of earned surplus. In these corporations, earned surplus does not offer any useful information to statement users about the firm's future dividend policy. Furthermore, a large portion of the earned surplus is, in essence, permanent capital and practically has the same degree of reliability as the stated capital. Creditors should rely upon earned surplus as well as the stated capital to provide a buffer for protection.

According to these writers, the legal aspects of owners' equity are usually irrelevant for all practical purposes; the reporting of the legal components is unnecessary unless the earned surplus is small.  

**Evaluation.**—In the preceding paragraph, the implication is that the creditors' margin of safety should be judged on the total owners' equity. The conclusion is that the amount of stated capital is irrelevant. But such a conclusion is misleading, for the evaluation of the margin of safety involves numerous factors. Some of the factors are the current ratio, the ratio of debt to equity, future earning power, priority of claims to assets, sinking fund requirements, and stipulations concerning additional debt. Two other factors are the size of the total owners' equity and its legal composition.

No one factor is the sole indicator of the creditors' margin of safety. Instead, all the above factors have to be taken into consideration; each one influences the evaluation. For instance, high earnings and a large amount of owners' equity both enhance the degree of creditors' safety. Likewise, a high amount of stated or restricted capital adds to the overall margin of safety while a

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relatively low amount of stated capital detracts from the reliability of the buffer.

In conclusion, the legal components of capital cannot be dismissed as being irrelevant to the creditors. The legal component of earned surplus is also a significant figure to the stockholders when the earned surplus is small.

Other Restrictions on Owners' Equity

A major disadvantage of the legal basis is that it reports only some of the restrictions on owners' equity. Creditors often impose restrictions that are more stringent than the statutory restrictions. This is discussed more fully in the next major section of this chapter.\(^{31}\)

Conclusions

Even though the amount of earned surplus may not always be an important figure to the stockholders, creditors have a more widespread use for the legal components of capital. The creditors use the amount of stated capital in evaluating their margin of safety regardless of whether the earned surplus is large or small. On this basis, the legal method of classification presents information that is useful to the statement readers. One drawback, however, is that the statutory classification sometimes reports only

\(^{31}\)Infra, pp. 165-72.
part of the restrictions on owners' equity.

There are at least two problems in classifying the owners' equity into its legal components. One difficulty is that some state statutes are incomplete or ambiguous as to how some items should be classified. The second difficulty is that the consolidated owners' equity commingles the capital of several legal entities. To evaluate the margin of safety or the availability of earned surplus for dividend purposes, the owners' equity of the individual corporations must be studied.

Classification by Restrictions on Owners' Equity

Inadequacy of Legal Basis to Report Restrictions

Statutory provisions do not constitute the only restrictions on the distribution of owners' equity. Agreements with creditors and preferred stockholders usually impose restrictions that are more stringent than those required by state corporate statutes. Under some state statutes, distributions of surplus or capital can be made under almost any circumstances which do not make the firm insolvent. In effect, some state statutes do not provide much protection to the creditors, and as a result, creditors impose additional restrictions for protection. Furthermore, the stated capital may be only a small part of the total owners' equity, and creditors impose additional
requirements to guarantee that most of the owners' equity is preserved.

Significance of Restrictions

Obviously, the added restrictions result in larger amounts of owners' equity that must be retained by the company. Sometimes the restrictions imposed by the creditors may be several times larger than the restrictions under the state corporate statutes.

The result is that a much higher percentage of owners' equity is precluded from use as a basis for declaring dividends. Some examples showing the effectiveness of creditors' restrictions are shown in Table I. In every company reported in the table, over 90 per cent of the total owners' equity is restricted whereas under statutory provisions, the restricted owners' equity would have been much less.

Even more effective is the relatively small amount of unrestricted owners' equity which the firms have available for declaring dividends. Only one of the companies shown in Table II barely has enough unrestricted owners' equity to cover two years of dividends. From the investor's point of view, the margin of safety between unrestricted owners' equity and the dividend payment is small.

Imposed dividend restrictions that exceed those specified by state statutes are probably the rule rather
# TABLE I

**THE EFFECT OF DEBT AGREEMENTS ON RESTRICTED OWNERS' EQUITY OF SELECTED CORPORATIONS***

*(in millions of dollars)*

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Par value</td>
<td>$34</td>
<td>$3</td>
<td>$19</td>
<td>$12</td>
<td>$138</td>
<td>$14</td>
</tr>
<tr>
<td>Capital surplus</td>
<td>191</td>
<td>53</td>
<td>90</td>
<td>211</td>
<td>--</td>
<td>51</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>145</td>
<td>55</td>
<td>201</td>
<td>452</td>
<td>689</td>
<td>77</td>
</tr>
<tr>
<td>Total owners' equity</td>
<td><strong>$370</strong></td>
<td><strong>$111</strong></td>
<td><strong>$310</strong></td>
<td><strong>$675</strong></td>
<td><strong>$827</strong></td>
<td><strong>$142</strong></td>
</tr>
<tr>
<td>Unrestricted owners' equity**</td>
<td>$12</td>
<td>$1.1</td>
<td>$20</td>
<td>$28</td>
<td>$68</td>
<td>$-0-</td>
</tr>
</tbody>
</table>

Percentage of restricted owners' equity to total owners' equity:

- Without the debt agreement***: 61% 50% 35% 33% 17% 46%
- With the debt agreement: 97% 99% 94% 96% 92% 100%

*Dates pertain to the annual corporate reports that are shown below as sources for the data.

**The debt agreements impose restrictions on dividends. The unrestricted owners' equity represents the amount that is legally available as a basis for declaring dividends.

***The capital surplus is included as part of the restricted amount.

 Brunswick Corporation, Annual Report, 1967, pp. 4-17.
TABLE II

NUMBER OF TIMES DIVIDENDS ARE COVERED BY UNRESTRICTED OWNERS' EQUITY IN SELECTED CORPORATIONS*
(in millions of dollars)

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total retained earnings</td>
<td>$145</td>
<td>$55</td>
<td>$201</td>
<td>$452</td>
<td>$689</td>
</tr>
<tr>
<td>Dividends paid during the year</td>
<td>$9.7</td>
<td>$2.3</td>
<td>$16.5</td>
<td>$13.5</td>
<td>$68</td>
</tr>
<tr>
<td>Unrestricted owners' equity at end of the year</td>
<td>$12</td>
<td>$1.1</td>
<td>$20</td>
<td>$28</td>
<td>$68</td>
</tr>
<tr>
<td>Number of times that dividends are covered by the ending unrestricted owners' equity</td>
<td>1.2x</td>
<td>.5x</td>
<td>1.2x</td>
<td>2.1x</td>
<td>1.0x</td>
</tr>
</tbody>
</table>

*Dates pertain to the annual corporate reports which are shown below.

than the exception. Of the 600 corporate financial statements surveyed in *Accounting Trends and Techniques* for 1967 and 1968, 411 of the corporations mentioned dividend restrictions on their retained earnings. In 1966, 399 corporations mentioned restrictions.\(^{32}\) Perusal through Moody's Industrial Manual also indicates that dividend restrictions are numerous and often substantial in size.

**Reporting of Restrictions on the Balance Sheet**

Creditors, investors, and financial analysts should be interested in all the restrictions on owners' equity. The total effect of the various restrictions has to be considered in determining how much of the owners' equity must be kept in the corporation and how much can be legally distributed. State corporate codes account for only part of the restrictions on owners' capital. The other restrictions are just as important and should receive as much attention as the statutory ones. However, the typical presentation of owners' equity gives more attention to the statutory restrictions by displaying them in the body of the balance sheet. The imposed restrictions, oftentimes much larger than the statutory ones, are usually subordinated and reported in a footnote.

For reporting purposes, the emphasis should be to clearly communicate the restrictions on owners' equity. The classification of owners' equity into its legal components does not always do this well. For instance, labeling a part of owners' equity as capital surplus does not specify whether this amount can be used for dividend or stock reacquisition purposes. Nor is the legal component retained earnings a relevant figure; instead the parts which must be retained and which need not be kept is more important. As most owners' equity sections are now prepared, the total retained earnings is shown in the body of the balance sheet whereas the restrictions are subordinated in the footnotes. This method of presentation seems to stress the wrong facts.

If the restrictions are to be emphasized, the presentation should do this directly rather than use the indirect method of the legal classification. A format of the owners' equity section which clearly labels the restricted and unrestricted parts provides the information which statement readers need.\(^{33}\)

Limitations of the Restriction Basis

The restrictions on the balance sheet are those that are in effect on the date of the financial statement. However, statement readers should be aware that the

\(^{33}\)For an example, see page 89.
restrictions are not necessarily permanent or long lasting. In fact, some of the statutory restrictions can be relaxed quite easily by corporations. For instance, stated capital can be reduced by a vote of the stockholders or sometimes by the directors alone.34 Such a transaction transfers stated capital to capital surplus which often has no statutory restrictions in some states. Stated capital can also be distributed if the corporation is in the business of exploiting wasting assets. And corporations are often permitted to acquire redeemable stock, to eliminate fractional shares through purchase, and to acquire the stock of dissenting stockholders even though the corporation does not have any surplus; such purchases would reduce the stated capital or unrestricted owners' equity.35

Other restrictions could also be temporary. For instance, a debt agreement may require that a specified amount of working capital be on hand before dividends can be paid. In a year when the working capital requirement is not met, the entire owners' equity is restricted. But in the following year, a large amount of owners' equity could


35 California Corporations Code, Sec. 1706; Louisiana Business Corporation Law (1968), Sec. 55.
again become unrestricted if the working capital requirement is met.

As is obvious, there are numerous ways in which restricted capital can be distributed. The amount that is restricted on the balance sheet can be changed or reduced shortly thereafter. Therefore, classifying the owners' equity into restricted and unrestricted parts may give the financial statement reader a false sense of security.

Another problem is in connection with consolidated statements. The problem is similar to the one in reporting the legal components of owners' equity. From the viewpoint of the parent company's stockholders and creditors, consolidated owners' equity consists of (1) restricted owners' equity of the parent; (2) unrestricted owners' equity of the parent corporation; and (3) the parent corporation's equity in the undistributed income of the subsidiaries.

Conclusion

Classification by restrictions presents information for which statement readers have a need. However, the restrictions are only those which apply on the date of the balance sheet; the restrictions may not be of a permanent nature.
Comparative Analysis of the Classification Methods

Evaluation by Usefulness

The preceding evaluations indicate that the most useful methods of classification are the division of owners' equity (1) by classes of stock and (2) by restrictions on distributions to stockholders. The effects of statutory classification can be incorporated into the restriction's method of classification. Statement readers, however, have little need for information about the sources of owners' equity or its utilization.

When there are two or more classes of stock, the question arises as to which of the two methods of classification should be the primary one. If the information of one classification method is more important than the information provided by the other, the more important information should probably be used in the presentation of owners' equity. This requires that a qualitative comparison be made to determine which information is more valuable.

However, the value of the data depends partly upon the reader. For instance, the unrestricted owners' equity is significant to the investor who is primarily interested in dividend payments. On the other hand, the rate of return on the common stock is important to the investor who is looking for growth rather than dividend payments; the capital contributed by the various classes of stockholders
is more valuable to this investor than the restricted and unrestricted amounts. In sum, the information provided by one of these two classification bases cannot be said to be more valuable than the information provided by the other.

Evaluation with Overall Classification of Equities

Another way to examine the problem is from the broad viewpoint of the equity side of the balance sheet.

As was discussed in Chapter II, the entity theory probably offers the most satisfactory explanation of the balance sheet. From the entity viewpoint, the balance sheet is a report about the firm's resources and the suppliers of the capital. The firm's capital has been supplied to it by various contributors, and the right side of the balance sheet is merely a listing of the suppliers. From the entity viewpoint, the stockholders are suppliers of capital just like the creditors. Because the stockholders are regarded as merely being one of several suppliers of capital, the stockholders are not accorded the special importance that is given them in the proprietary theory.

The preferred stockholders and the common stockholders are two separate suppliers of capital. Each class is a distinct source of capital just as bondholders are a source of long-term capital that is distinct from a financial institution supplying capital on a long-term note. In
other words, when there are two or more classes of stockholders, they should not be thought of as being one source of capital; each class of stock is a separate source.

For presentation purposes on the balance sheet, the suppliers of capital are grouped under one of several headings describing the general relationship of the capital suppliers to the firm. The three most common groups are short-term creditors, long-term creditors, and stockholders.

The equity of each class of stockholders should be listed and clearly presented in the stockholders' equity section. As has been emphasized, each class of stockholders is a separate supplier of capital and, as such, should not be obscured. There is no reason for the identity of any class of stock to be lost or commingled with the other classes of stock simply because they are all grouped together in the stockholders' equity section. The purpose of grouping items is to organize the information into an orderly presentation, not to hide the sources of owners' equity.

Classifying owners' equity by classes of stock is consistent with the way in which other sections on the

36 Of course, many sources of capital are combined for reporting purposes. Sources are combined when they are small or when their distinction from other suppliers is unimportant. However, the equity of each class of stock is useful information to the users of financial statements. The separate identities of each class of shareholders should be maintained under the stockholders' equity headings.
equity side of the balance sheet are reported. Classification of the other sections (current debt and long-term debt) show the various sources or suppliers of capital. Similarly, the classification of stockholders' equity by types of stock would show the suppliers of stockholders' capital. In this way, the entire right side of the balance sheet would be classified according to the same principle.

The equity assigned to each class of stock should represent the amount of capital contributed by each class of shareholders. Since the equities represent sources and suppliers of capital, the contributed amount is a more logical valuation basis than the liquidation or call values. The common stock equity should also include the firm's undistributed earnings; the undistributed earnings is capital being supplied at the expense of the common stockholders. However, if there are dividends in arrears, a proper amount of the undistributed earnings should be assigned to the preferred stock equity.

Two-Stage Method of Classification

Consistency with other equity sections.--A two-stage classification method could be incorporated so that both the restrictions and the classes of stock could be shown in the body of the balance sheet. The first stage should be classified by types of stock, and the restrictions should be shown in the second stage. To reverse the classification
and show restrictions in the first stage and the classes of stock in the second stage results in a framework which is not uniform. The following example illustrates the point:

Current debt:
Supplied by ....
Supplied by ....
Supplied by ....

Long-term debt:
Supplied by ....
Supplied by ....

Stockholders' equity:
Restricted Capital:
Supplied by preferred stockholders
Supplied by common stockholders

Unrestricted capital:
Supplied by preferred stockholders
Supplied by common stockholders

As should be noticed, the sources of capital are shown in the first stage of the current debt and long-term debt sections and in the second stage of the stockholders' equity section. The statement would be better organized if the suppliers of resources were shown in the same stage in every section.

Classifying restrictions in the first stage and classes of stock in the second stage could be justified if it presents data of a more informative nature than the reverse order. But as was mentioned earlier, there is no clear-cut answer as to whether the equity by classes of stock or restrictions on stockholders' equity presents the more valuable information. If neither is considered to be

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37 Supra, pp. 173-74.
superior to the other, the overall classification principle of the stockholders' equity section should probably be consistent with that of the other equity sections.

When there is only one class of stock, the restrictions can be incorporated into the body of the balance sheet. The following format should be used for the owners' equity section.

Owners' Equity:
Common Stock:
  Restricted   xx
  Unrestricted  xx  xx

The common stock nomenclature should be shown to indicate the supplier of owners' equity. This is in accordance with the reporting of the other equities. The common stock is then subdivided into its restricted and unrestricted parts.

Weaknesses of two-stage classification.--Whenever there are two or more classes of stock, the two-stage method of classification has several weaknesses. For one thing, the data shown in the second stage is often split and shown in two different locations. To get the complete information about some items, figures from several sources must be combined. In the following example, both of the restricted amounts must be combined to determine the total restrictions. Likewise, the unrestricted owners' equity from two locations must be added to get the total amount available for dividends.
Stockholders' Equity:

Preferred Stock:
- Restricted
- Unrestricted

Common Stock:
- Restricted
- Unrestricted

Total Stockholders' Equity

The presentation in the preceding format could also result in a misleading inference. The unskilled reader might get the impression that each class of stock is entitled to dividends only from the unrestricted owners' equity shown for that respective class of stock. This would be an erroneous idea.

From a technical legal viewpoint, the stated capital component of restricted capital is not associated with any class of stock. According to Hills,

... Stated capital does not "represent" and has no dependent relation to shares or classes of shares. To repeat, it is an independent amount in dollars or dollar values serving as a limitation on the rights of shareholders to withdraw (by dividends or by the purchase of shares, except in special circumstances provided by statute) any assets of the corporation. The amount of stated capital is computed by adding together its various component amounts, but such component amounts, having become a part of the total capital amount, are merged into such total. Stated capital is the single total amount.38

To divide each class's equity into restricted and unrestricted parts is improper from a legal point of view.

The value of the two-stage classification method is

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questionable when it divides information into parts which, individually, are irrelevant. For instance, the creditor does not care how much equity of each class of stock is considered to be restricted. To the creditor, only the total amount of restricted capital is relevant, for the total amount serves as the buffer which is usually not distributable. And only the total of unrestricted owners' equity is relevant to the stockholder interested in dividends. Dividends can be declared on any unrestricted owners' equity regardless of how the unrestricted owners' equity is classified in the two-stage classification. In conclusion, dividing the equity of each class of stock into restricted and unrestricted amounts is useless and has no effect in law. A two-stage method of classification does not serve a useful purpose when there is more than one class of stock.

Footnotes and Classification

An alternative is to report only the total owners' equity in the body of the balance sheet. The equity of each class of stock and the restrictions on owners' capital would be presented in the footnotes. This approach avoids the classification problem, yet reports the relevant facts about the owners' equity.

However, a criticism of the preceding alternative is that footnotes should not be used as substitutes for proper
classification. Information that is capable of being reported in the body of the balance sheet should be shown in the body of the financial statements, not in the footnotes. If the trend of reporting increasing amounts of data in the footnotes continues, financial statements will become textual descriptions rather than codified summaries. The reporting of data in the body of the financial statements should be encouraged.

Tangible Owners' Equity

As was noted in Chapter IV, tangible owners' equity is frequently used in calculating financial ratios. Therefore, the division of owners' equity into its tangible and intangible parts would be a useful method of classification on the balance sheet.

However, there are more useful methods of classifying owners' equity than can be presented on the balance sheet. Obviously, several useful methods have to be eliminated. The classification of owners' equity into tangible and intangible parts is dispensable and can be left off the balance sheet without any harm. Statement users can calculate the tangible owners' equity from the data usually presented in the balance sheet.

39 Hendriksen, Accounting Theory, p. 459.
Conclusions

The equity of each class of stock and the restrictions on distributions are both useful items of information to statement readers, and both items should be reported on the balance sheet.

A simple solution is to report the owners' equity as a total figure in the balance sheet and present all the other data about owners' equity in the footnotes. However, overreliance on footnotes is unsatisfactory and should be avoided.

Either the equity of each class of stock or the restrictions have to be treated as the primary method of classification in the owners' equity section. As was seen, neither of the two types of information can be considered to be more important than the other. Importance of the information does not provide any basis for choosing a primary method of classification. However, another criterion is to classify the entire equity side of the balance sheet according to a like principle. Under the entity theory, the right side of the balance sheet is similar in nature, and the classification of all the equities in a like manner is logical. By classifying the owners' equity section according to classes of stock, the entire equity side shows the various suppliers of capital. For this latter reason, classification by classes of stock appears to be the better basis for presenting owners' equity in the balance sheet.
If the classes of stock are used as the primary classification basis, the restrictions should still be reported in some way. One way is to show the restrictions in the second stage of classification. This is satisfactory when there is only one class of stock. However, if there are two or more classes of stock, reporting the restrictions in the second stage divides useful data into irrelevant parts. It can also result in misleading inferences. Reporting the restrictions in the footnotes is a better alternative if there is more than one class of stock.

In one respect, the choice for the primary classification method probably is not crucial. The reason is that the information not presented in the classified parts of the owners' equity section would be shown in the footnotes. For instance, the liquidation value and call price of preferred stock are usually shown in the footnotes of financial statements. If necessary, the capital contributed by preferred stockholders could also be shown there, too. Likewise, the footnotes often include a description of the restrictions on distributions to stockholders. The amounts of the restricted and unrestricted owners' capital could be indicated in the same footnote.

Nevertheless, whatever method is selected should communicate useful data about the owners' equity. A definite principle for classification would probably improve the communication of ideas to statement readers and would
reduce some of the misinterpretations that can otherwise be made about owners' equity. A specified classification objective also provides a guideline for solving problems in the allocation of owners' equity to the various accounts.

Summary

In this chapter, the various classification bases were examined as to their usefulness.

The source basis of classification does not convey any information that is generally needed by statement readers. If anything, the data about sources may be misinterpreted. The origins of owners' equity are sometimes misused to study profitability, to ascertain whether a dividend received by a stockholder is income, and to indicate the owners' equity that can be distributed.

Neither is the utilization basis a desirable method for presenting owners' equity. The underlying assumptions regarding the uses are not well established. However, the reader of the statement can prepare a computation of the uses from the balance sheet using his own assumptions.

Reporting the owners' equity by classes of stock does provide information that is useful to creditors and investors. The equity for each class is needed for determining the rate of return on common stock and also for valuing the preferred stock during liquidation or redemption.
The legal basis is inadequate in that it reports only part of the restrictions on owners' equity. However, a larger concept of restrictions that is useful includes the restrictions that are imposed by debt agreements. This gives a more complete picture of the capital that may and may not be distributed to the stockholders.

The two most useful methods of classification are those that show the restrictions and show the equity of each class of stock. But since both classification bases are important, the criterion of usefulness alone is not adequate to select one method as the better one for statement presentation. However, the division by classes of stock is more compatible with the classification principle used in the other equity sections of the balance sheet. On this basis, classification by types of stock appears to be the best method for reporting owners' equity on the balance sheet. The restrictions can be shown in the second stage of classification if there is only one class of stock. However, if there are two or more classes of stock, the restrictions are best reported in the footnotes to the financial statements.
CHAPTER VI

SUMMARY

Problem and Purpose of the Study

The present manner in which the owners' equity section is classified does not seem to follow any clear principle. The usual presentation of the owners' equity section is not classified according to its legal components. Nor is the owners' equity section classified into its sources; the sources are obscured by transfers from retained earnings to paid-in capital, as in stock dividends. Neither does the owners' equity section convey a realistic amount of permanently committed capital. Nor is the equity of each class of stock shown when there are two or more classes of stock.

A need exists for a definite objective or principle to be used in classifying owners' equity. The lack of a classification principle can result in erroneous interpretations by statement readers. For instance, many readers probably presume that the legal components are reflected in the owners' equity section. Likewise, others probably presume that the retained earnings account shows the amount of the undistributed earnings; transfers of earnings to
other capital accounts are overlooked. Some readers may also attach too much significance to the retained earnings figure.

A second need for a definite classification basis is to serve as an accounting principle. Such a principle would provide a guide for the reporting and presentation of the owners' equity section. A classification principle would also be useful in resolving problems concerning the allocation of owners' equity among its various accounts. For instance, the controversies in accounting for stock dividends and treasury stock might be narrowed if there was a generally accepted objective for classifying owners' equity.

There are many possible ways to classify owners' equity. It can be classified by each of its various traits and characteristics. However, each way is not equally valuable; some are more useful than others. The purpose of this study has been to determine which method of classifying owners' equity is most suitable for reporting purposes. Since the financial statements should communicate data that helps investors and creditors in making their decisions, usefulness of the data was the major criterion by which the classification of owners' equity was judged.
To evaluate the usefulness of the classification bases, the statement readers' needs for information about owners' equity were examined.

In financial ratio analysis, total owners' equity and tangible owners' equity are the two most frequently used figures concerning owners' equity. Further breakdowns of owners' equity are seldom used in ratio analysis. One exception, however, is when there are several classes of stock outstanding. The allocation of capital to each class of stock is necessary for computing (1) the rate of return on common stock, (2) the book value per share of preferred and common stock, and (3) the percentage of a class' equity to the firm's total capital.

In addition to use in ratio analysis, statement readers may be interested in other pieces of information about owners' equity. The restrictions on owners' equity are one of numerous factors used by creditors in judging the reliability of capital and evaluating the margin of safety. The stockholders may also have an interest in the amount of unrestricted owners' equity. The unrestricted owners' equity acts as a ceiling on the amount of dividends that can legally be declared. However, the legal maximum is just one of several factors used in studying dividend policy.
The call price and the liquidation value of preferred stock may also be of interest to the preferred stockholders.

The Nature of Owners' Equity

The balance sheet and owners' equity section are best explained from the entity point of view. The balance sheet is a report about the firm's capital. The assets represent the form in which the capital is held while the equity side of the balance sheet represents the sources of the firm's capital. From the entity's viewpoint, the creditors and stockholders are similar in the respect that both are suppliers of assets.

Owners' equity is one of several sources of the firm's assets and represents the amount of the resources that have been derived from stockholders. The owners' equity includes the amount of assets that were received from stockholders, past or present, who purchased shares of stock when the shares were originally issued. Owners' equity also includes any assets the corporation holds because of earnings that have not yet been distributed to the stockholders.

After the corporation initially issues shares of stock, stockholders buy and sell the shares at prices that are not the same as the book value per share on the corporation's books. The corporation does not record the prices
of the exchanges among the stockholders. Consequently, the owners' equity on the balance sheet does not reflect the amounts paid by the current stockholders to acquire their holdings. In this respect, owners' equity is not reported from the proprietary viewpoint. Instead, owners' equity is reported from the point of view of the entity.

Classification Bases of Owners' Equity

Five ways of classifying the owners' equity section are by its sources, legal components, restrictions, equity by classes of stock, and utilization. Each basis was examined in the study as to its mechanics of classification and its usefulness.

Source Basis of Classification

The source basis of classification attempts to report how much of the owners' equity is attributable to profitable operations and how much is attributable to capital paid in by the stockholders. Appraisal increases and gifts of property are also considered to be sources of owners' equity, but these sources are not common.

Increases in owners' equity can usually be traced to a specific source. Once in the business, however, owners' equity is homogeneous and becomes commingled with the owners' equity from other sources. Consequently, decreases of owners' equity cannot be physically identified with any
source. For example, a dividend to stockholders is generally considered to be a distribution of earnings. But the source of the dividend could be challenged by maintaining that paid-in capital is being returned before earnings are distributed. As is evident, there is no way to prove what source of owners' equity is being distributed.

Under the source basis of classification, however, assumptions are made as to the sources that are affected by different kinds of decreases in owners' equity. Most of the assumptions are, in general, very well accepted and are seldom questioned. One exception exists, though, in accounting for the sources that are affected by treasury stock transactions.

The source basis has been supported by many accountants as the ideal principle for classifying owners' equity. But upon close examination, the information about the sources of owners' equity is not very relevant. The size of retained earnings is not a reliable indicator of the past success of an enterprise. For instance, an enterprise may have had large earnings but paid them out as dividends. In this case, a small balance of retained earnings is not a sign of poor earning power. Furthermore, an absolute amount of retained earnings does not indicate over what time span the earnings have been accumulated. To study a firm's profitability, past income statements are a better guide than retained earnings.
The sources of dividend distributions are not relevant to stockholders in determining whether or not they have had an income. Whenever a stockholder purchases his stock from a prior owner, the new stockholder is acquiring the book value of the shares. The book value most likely includes some retained earnings. Therefore, if the corporation pays a dividend based upon retained earnings created prior to the new stockholder's acquisition, the dividend is not income to the stockholder; instead, the dividend represents a return of capital. The book value per share of retained earnings seldom corresponds to the past earnings of the individual stockholders. Thus, the source of a corporation's distribution is irrelevant in determining whether or not the dividend is income to the stockholder.

Nor do the sources of owners' equity indicate the amount of capital that can be distributed as dividends. The legal availability of capital for declaring dividends is not based upon the origins of the owners' equity.

In conclusion, the source basis does not convey any information that is useful in making investment or credit decisions. Ratio analysis does not make use of any data about the sources of owners' equity. Nor are the sources helpful in studying profitability, determining income to the investor, or appraising dividend policy.
Statutory Classification

The legal classification of owners' equity is based upon the corporation statutes of the individual states. According to most state statutes, owners' equity is divided into stated capital, earned surplus, and capital surplus.

The stated capital is not normally intended to be distributed although it can be disbursed in numerous states under special circumstances. The amount of the stated capital must usually be at least as large as the aggregate par value of the issued shares. However, the stated capital can be larger than the par value.

Earned surplus is the undistributed earnings less any amounts that have been transferred to stated capital or capital surplus. Earned surplus is normally the legal basis on which dividends are declared.

Capital surplus is any owners' equity not classified as stated capital or earned surplus. The capital surplus can usually be used in most states as a basis for declaring dividends.

In general, there are not many problems in classifying owners' equity in accordance with the legal basis. The most frequent problem is that the statutes in some states are not clear as to how some transactions should be classified. For instance, the statutes in several states are either ambiguous or silent concerning the classification of
appraisal capital and the effects of treasury stock transactions on components of owners' equity.

At first glance, the value of the legal classification for statement readers seems to be in determining the owners' equity which must legally be retained in the business and that which may be distributed. However, the legal classification falls short of this objective in two ways. For one thing, the legal basis of classification does not indicate whether capital surplus can be used for making distributions to the stockholders. A second weakness is that the statutory components do not include the effects of dividend restrictions that are imposed by agreements with creditors and preferred stockholders. The restrictions imposed by the creditors and preferred stockholders are more severe than the statutory ones. Consequently, the legal classification is only a partial indicator of the owners' equity that must be retained in the firm.

Classification by Restrictions

The restrictions method of reporting owners' equity stresses the amounts that can and cannot be distributed. The restrictions are based upon the statutory and contractual requirements. These types of restrictions can be determined quite readily, and they explain the dividend limitations imposed by outsiders on the actions of the corporation.
Managerial restrictions should be omitted from the classification of owners' equity because of their awkwardness in reporting. If managerial restrictions are listed, the restrictions tend to represent the owners' equity necessary for operating the business. Consequently, the unrestricted owners' equity would have the connotation that it is not needed in the business. But it is doubtful that a firm would be willing to label a portion of its owners' equity as available for dividends, yet retained. Stockholders would surely demand that the available amount be distributed as dividends. On the other hand, if the entire owners' equity is always restricted but dividends are continually paid, the managerial restrictions are useless for studying dividend policy.

The effects of the restrictions should be emphasized in the classification by restrictions. The classification should clearly indicate how much of the owners' equity is distributable and how much is not distributable. If applicable, owners' equity that is distributable to preferred stockholders but not to common stockholders should also be indicated.

Classification by restrictions is more relevant to statement readers than the classification by statutes. Classification by restrictions provides a more complete portrayal of the legal constraints on withdrawals of owners' than is shown by statutory classification. The restrictions
method also stresses specifically a fact about owners' equity that creditors and stockholders want to know.

**Classification by Equities**

Whenever there is more than one class of stock, the owners' equity can be classified on the basis of the equity of each class of stock. The major problem is on what basis to allocate the owners' equity to each class. There are several alternatives that can be used. In all the alternatives, a specific amount is assigned to the equity of preferred stock, and any residual owners' equity is assigned to the common stock. The alternative methods of valuing preferred stock are by par value, liquidation value, call price, and the capital paid in by preferred stockholders.

There are two major uses for information about the equity of each class of stock. The differentiation between classes is necessary in computing rates of return on the preferred stock and common stock. The statement readers may also want to know about the amount that would be paid to preferred stockholders if their stock is redeemed or if the company is liquidated.

In computing the rates of return, some distortions can result when the par value, liquidation value, or the call price is assigned to the preferred stock. The most satisfactory basis for computing the rate of return is to assign the capital paid in by preferred stockholders to the
preferred stock equity. The remaining equity is assigned to the common stock. However, if the objective is to report the amount to be paid to preferred stockholders upon termination of their stock, the call price or liquidation value would be assigned to preferred stock.

As is evident, the liquidation value, the call price, and the capital contributed by preferred stockholders are all useful information for certain types of inquiries by statement readers. Par value has little usefulness. However, only one of the three relevant values can be used for classifying owners' equity in the body of the balance sheet. The other two values must appear either parenthetically or in footnotes. The choice of the value to be used for classifying owners' equity on the balance sheet is taken up later.

Classification by Utilization

Another classification basis attempts to explain the use that is made of the resources financed by the owners. This method requires that several assumptions be made as to the assets that are financed by the owners' equity. Some of the assumptions are well accepted while some others are not.

The rationale of the utilization classification basis is that the firm ought to explain to its owners how their equity is being used; the enterprise should justify
why the owners' equity is needed in the business. However, there is no evidence in the literature of investment and financial analysis that the form of resources financed by the owners' equity is significant information. Creditors and investors apparently do not need this type of information in evaluating a firm.

The controversial methodology and the irrelevance of the information about the use of owners' equity do not provide much support for reporting the utilization basis on the balance sheet. In the rare instance that someone does want this type of information, one can prepare it himself from the assets and equities shown on the balance sheet. Furthermore, the user can employ whatever assumptions he believes are correct. In sum, there is little justification for the utilization basis of classifying owners' equity in the balance sheet.

**Evaluation and Conclusions**

The two most useful principles for classifying owners' equity are by restrictions and by classes of stock. Classification by sources and by utilization provide little, if any, useful information. The objective of the legal classification basis is better achieved through the restrictions method of classification.

Division by classes of stock appears to be the best principle for classifying the owners' equity on the balance
sheet. This method furnishes information that is useful to statement readers, and the principle is also consistent with the overall classification concept used on the equity side of the balance sheet. As has been noted, the equity side of the balance sheet indicates the sources of the firm's capital. The items listed under the current liabilities and long-term debt sections identify major groups of capital suppliers such as trade creditors, banks, employees, and bondholders. Likewise, classifying owners' equity by classes of stock is a way of disclosing the various suppliers of capital and is similar in principle with the classification of liabilities. Although the restrictions method conveys useful information, it does not identify the sources or suppliers of capital. For these reasons, reporting the equity by classes of stock seems to be the best method of balance sheet presentation.

The equity assigned to each class of preferred stock should be based upon the capital contributed by each group of preferred stockholders. The residual equity would belong to the common stockholders and would be equal to their contributed capital plus the undistributed earnings. Since the equities represent sources of capital, the contributed amount is a more logical valuation basis than the liquidation or call values.

If there is only one class of stock outstanding, the restrictions can be reported in the second level of a
two-stage classification. However, showing the restrictions in the second stage is awkward and sometimes misleading if there is more than one class of stock. Therefore, whenever two or more classes of capital stock are outstanding, the restrictions on owners' equity are best reported in the footnotes.
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APPENDIX I

MATERIAL SURVEYED FOR THE USES OF OWNERS' EQUITY IN FINANCIAL RATIO ANALYSIS

Books on Financial Statement Analysis


Books on Investment Principles


**Books on Accounting Principles**


**Sources of Standard Ratios**


FINANCIAL DATA AND RATIOS--GLEN ALDEN CORPORATION

Data from the Financial Statements:

<table>
<thead>
<tr>
<th></th>
<th>1967 (data includes the poolings)*</th>
<th>1966 (not adjusted for the poolings)**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total owners' equity</td>
<td>$ 215.8 million</td>
<td>$ 70.0 million</td>
</tr>
<tr>
<td>Stated value of preferred stock</td>
<td>51.0 million</td>
<td>0</td>
</tr>
<tr>
<td>Liquidation value of preferred stock</td>
<td>346.0 million</td>
<td>0</td>
</tr>
<tr>
<td>Net income</td>
<td>17.6 million</td>
<td>6.4 million</td>
</tr>
<tr>
<td>Number of outstanding shares of common stock</td>
<td>5.5 million</td>
<td>4.8 million</td>
</tr>
</tbody>
</table>

Other Data:

Annualized dividends on preferred stock
(number of shares x preferred dividend rate)
Capital contributed by preferred stockholders***

<table>
<thead>
<tr>
<th></th>
<th>10.4 million</th>
<th>0</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>132.0 million</td>
<td>0</td>
</tr>
</tbody>
</table>


***The capital invested by the preferred stockholders was computed by finding the difference in owners' equity at December 31, 1966, on (1) a balance sheet prepared before the pooling and (2) a balance sheet that was subsequently adjusted to reflect the pooling. The result is only an approximation of the owners' equity added by the pooling. The acquired firms may have had some net income or other changes that took place in owners' equity after December 31, 1966, but prior to the poolings during 1967. However, these changes are not shown in the financial reports and, therefore, could not be taken into consideration in determining the equity provided by the preferred stockholders.
Values Calculated from Previous Data:

<table>
<thead>
<tr>
<th></th>
<th>1967 (data includes the poolings)</th>
<th>1966 (not adjusted for the poolings)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock equity--</td>
<td>$(130.2 million)</td>
<td>$ 70.0 million</td>
</tr>
<tr>
<td>(preferred stock valued</td>
<td></td>
<td></td>
</tr>
<tr>
<td>at liquidation value)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock equity--</td>
<td>164.8 million</td>
<td>70.0 million</td>
</tr>
<tr>
<td>(preferred stock valued</td>
<td></td>
<td></td>
</tr>
<tr>
<td>at stated value)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock equity--</td>
<td>83.8 million</td>
<td>70.0 million</td>
</tr>
<tr>
<td>(preferred stock valued</td>
<td></td>
<td></td>
</tr>
<tr>
<td>at invested amount)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income for common</td>
<td>7.2 million</td>
<td>6.4 million</td>
</tr>
<tr>
<td>stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earnings per share of</td>
<td>1.31</td>
<td>1.33</td>
</tr>
<tr>
<td>common stock</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Financial Ratios:

Rate of return on common stock equity--1966  
\[
\frac{6.4 \text{ million}}{70.0 \text{ million}} = 9.1\%
\]

Rate of return on common stock equity--1967 (preferred stock valued at assumed liquidation value of $210 million)  
\[
\frac{7.2 \text{ million}}{6.0 \text{ million}} = 120\%
\]

Rate of return on common stock equity--1967 (preferred stock valued at stated value)  
\[
\frac{7.2 \text{ million}}{165 \text{ million}} = 4.4\%
\]

Rate of return on common stock equity--1967 (preferred stock valued at invested amount)  
\[
\frac{7.2 \text{ million}}{84 \text{ million}} = 8.6\%
\]
VITA

Kermit Charles Natho, Jr., the son of Kermit Charles and Hannah Peterson Natho, was born in McAllen, Texas, on June 27, 1938. He received his elementary and secondary education in the public schools of Mercedes, Texas, graduating from Mercedes High School in June, 1956.

In the following September, he entered Pan American College in Edinburg, Texas, and received the degree of Bachelor of Arts in June, 1960. From 1957 through 1960, he was also on the staff of Lauder and Kennedy, Certified Public Accountants, in Mercedes, Texas.

In September, 1960, he entered the Graduate School of Louisiana State University in Baton Rouge. He received the degree of Master of Business Administration in June, 1962. In September, 1962, he re-enrolled in the Graduate School of Louisiana State University. During his time at that institution, he served as a Graduate Assistant in the Department of Accounting.

He served as Assistant Professor of Accounting at Georgia State College, Atlanta, Georgia, for the academic years 1966 through 1968. He is also a Certified Public Accountant in Texas and Georgia.

He is currently a candidate for the degree of Doctor of Philosophy in Accounting.
EXAMINATION AND THESIS REPORT

Candidate: Kermit Charles Natho, Jr.

Major Field: Accounting

Title of Thesis: "A Study of the Principles Used in the Classification of the Owners' Equity Section of the Balance Sheet"

Approved:

[Signatures]

Major Professor and Chairman

Dean of the Graduate School

EXAMINING COMMITTEE:

[Signatures]

Date of Examination: December 4, 1969