AN EVALUATION OF THE ACCOUNTING PROVISIONS CONTAINED
IN THE OHIO GENERAL CORPORATION LAW

DISSERTATION

Presented in Partial Fulfillment of the Requirements
for the Degree Doctor of Philosophy in the
Graduate School of The Ohio State
University

By

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The Ohio State University
1957

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Chapter I

Introduction

Function of Corporate Law

State corporation laws provide a means by which individuals may employ the corporate form of organization in the conduct of business activities. Primarily these laws serve as a device permitting incorporation, i.e., by issuance of a charter, upon fulfillment of organizational requirements, permission is granted to operate as a corporate unit. A second function is to provide a basis for equitably maintaining the rights of both present and future owners and creditors.

The nature of the corporation is such that insiders, the corporate management, may have undue advantage over the other parties involved unless the laws provide adequate safeguards. The fact that the corporation is viewed as a separate legal entity apart from its shareholders has created a tendency for owners to be less concerned with operating policies as the enterprise grows larger. As a practical matter today, the position of a shareholder in a large corporation is not unlike that of a long-term bondholder, despite the fact that legally the shareholder is recognized as an owner. The separation of ownership and management, with the concurrent growth in size of the corporate unit, has reduced the shareholder’s ability to exercise effectively the rights which are inherent in stock ownership.

Creditors, as outsiders who have advanced assets to the enterprise, can look only to the corporate funds for satisfaction
of their claims, as shareholders are granted limited liability for corporate debt. Unless restrictions are placed on corporate activities, creditor rights may be violated by excessive distributions of assets to owners.

Statement of the Problem

One means by which the rights of owners and creditors may be achieved is by requiring, through legislation, that desirable standards of accountability and disclosure be maintained for those financial transactions affecting corporate equities. At the present time the legal requirements relating to accounting matters are not in complete agreement with the practices which the accounting profession believes are the most desirable.

In the interest of the stockholder group and the general public, accountants have attempted to set forth appropriate principles and procedures for handling corporate financial transactions and to maintain certain standards for disclosure. Their objectives in establishing accountability for corporate equities should be the same as those of corporate law.

There is a need for investigating the standards of accountability and disclosure contained in corporate law and reconciling them with the views accountants hold. Inquiry should be made to determine (1) whether or not the accounting requirements contained in corporate laws are adequate as they are now stated, and (2) whether or not the practices advocated by accountants are more or less desirable than the requirements set forth in the law.
If the provisions of the laws are not adequate, then appropriate accounting requirements should be formulated.

The only acceptable criterion for judging the propriety of any rule of accounting or of any law is whether or not it is in the public interest. Determination of desirable public policy in corporate activities must stem from considerations of the interests of creditors, owners, and the general public.

The essential characteristic of the modern profit-seeking corporation is the dedication of a capital fund to the particular activities for which the enterprise is organized. Such a commitment of properties carries with it the logical proposition that the fund is to be preserved and that asset distributions are to be made from income. Since corporate capital is obtained from investors, either as creditors or owners, and since the general concept of investments, surplus and dividends appears to be predicated upon this distinction between capital and income, it is desirable public policy that the law provide a means for maintaining such a distinction. It is in the public interest that the equities of the various parties, representing their investments and interests, be accounted for accurately so that none of their rights will be violated. There also must be an adequate disclosure of all pertinent information. Financial reporting is the means of disclosure and it is in the public interest that the meaning and intent of the laws be understood and conveyed. Inconsistencies between accounting practices and legal requirements
are misleading and not in the public interest. Desirable public policy should be the objective of both and they should be in agreement.

Purpose of Study

The purpose of this study is to determine the most desirable accounting requirements to be embodied in the corporate laws. The Ohio General Corporation Law\(^1\) has been selected for examination. The requirements which it sets forth are to be compared with the accounting principles and procedures which have been promulgated by the accounting profession. The validity of both the law and the accounting rules are to be judged in light of desirable public policy for determination of the soundest legal requirements.

Scope of Study

The investigation of the Ohio Corporation Act has been limited to those sections which contain significant accounting problems. Specifically, the major areas selected for examination are: (1) Stated (legal) capital, (2) Surplus, (3) Dividends, (4) Re-acquisition of shares, (5) Mergers and Consolidations, (6) Reporting and disclosure requirements, (7) Definition of terms.

In order to determine the legal point of view, attorneys who have been instrumental in the drafting of the Ohio Corporation Act have been interviewed. Inquiry was made in the interviews as

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\(^1\)Ohio Revised Code, Chapter 1701, Corporations for Profit (hereinafter cited as RC).
to the following points: (1) the meaning, in a legal sense, of the terminology used in the Code in instances where explicit definitions are not set forth, (2) the purposes the various requirements are intended to serve, (3) the extent to which the legal requirements imply an exact accounting treatment, (4) any significant legislative history in the development of these requirements. Additional explanations have been obtained from the reports of the legislative drafting committees.

The principles and procedures advocated by the accounting profession are reviewed and compared with the legal requirements contained in the corporate code. In determination of "sound accounting," i.e., the thinking of the accounting profession, reference has been made to: (1) statements issued by the Research Committee of the American Institute of Certified Public Accountants, (2) statements issued by the Committee on Concepts and Standards of the American Accounting Association, (3) accounting releases of the Securities and Exchange Commission, (4) statements issued by the New York Stock Exchange, (5) textbooks and other writings in the field of accounting.
Chapter II
Stated Capital

Legal Requirements

The Ohio General Corporation Act contains the following provisions relating to stated capital and the reduction of stated capital:

Stated Capital

(A) Every corporation shall have and shall carry upon its books a stated capital for each class of outstanding shares. The stated capital of each outstanding share with par value shall be not less than its par value. The stated capital of the corporation shall be the aggregate stated capital of all classes of outstanding shares, which at no time shall be less than five hundred dollars. The stated capital of every share of a particular class outstanding at a particular time shall be identical.

(3) Subject to the provisions of division (A) of this section:

(1) The stated capital of shares issued otherwise than upon conversion, change, exchange, merger, consolidation, or reorganization shall be the amount of consideration for such shares, unless prior to the execution and delivery of the certificates for such shares the incorporators, directors, or shareholders, as the case may be, who fix the consideration or otherwise determine the value of any consideration for such shares, specify the portion of the consideration that shall constitute stated capital, whereupon any excess over such portion shall be capital surplus; provided that in the case of shares having preference in the event of involuntary liquidation of the corporation, the portion of the consideration that shall constitute stated capital shall be not less than the lesser of the entire consideration for such shares or the amount of such preference;

1RC, Sec. 1701.30 (stated capital), Sec. 1701.31 (reduction of stated capital).
(2) Unless the express terms of convertible shares provide that upon the exercise of conversion rights the stated capital of the corporation shall be increased or reduced, the stated capital of the shares issued upon the exercise of such conversion rights shall be the stated capital of the convertible shares so converted;

(3) Unless the terms of convertible obligations provide that upon the exercise of conversion rights the stated capital of the corporation shall be increased otherwise than as herein provided, the stated capital of the shares issued upon the exercise of such conversion rights shall be an amount equal to the principal amount of the convertible obligations so converted;

(4) Unless the amendment to the articles which effects any change in outstanding shares provides that upon such change the stated capital of the corporation shall be increased or reduced, the stated capital of the shares issued upon such change shall be the stated capital of the shares so changed;

(5) Unless the terms of an exchange of shares provide that upon such exchange the stated capital of the corporation shall be increased, the stated capital of the shares issued upon such exchange shall be the stated capital of the shares so exchanged;

(6) The stated capital of each class of shares to be outstanding at the time a merger, consolidation, or reorganization becomes effective shall be the amount set forth or provided for in the agreement of merger, agreement of consolidation, or plan of reorganization, as the case may be.

(C) The stated capital of a class of outstanding shares with or without par value may be increased by a transfer from any surplus however created to stated capital by order of the directors for the purpose of increasing such stated capital or upon payment of dividends in shares of such class, and may be reduced in any way provided for in section 1701.31 of the Revised Code.

(D) When a corporation having outstanding shares of more than one class has a stated capital applicable
to two or more of the classes and the amount of stated capital of a particular class cannot otherwise be readily determined, the directors of the corporation may make such determination, subject to the provisions of division (A) of this section.

Reduction of Stated Capital

A corporation shall not take any action which will require or result in reduction of its stated capital to an amount less than five hundred dollars or, with respect to the stated capital of each outstanding share with par value, to less than the par value of such share. Subject to such limitation and to such provisions as are set forth in the articles or in any contract or obligation:

(A) Whenever an outstanding redeemable share is redeemed by the corporation, or an outstanding share is purchased or otherwise acquired by the issuing corporation (otherwise than upon conversion, change, or exchange), the stated capital of the class to which such redeemed, purchased, or acquired share belongs shall thereby be reduced by an amount equal to the stated capital of such share;

(B) Whenever an outstanding share is released from subscription, the stated capital of the class to which such share belongs shall thereby be reduced by an amount equal to the stated capital of such share;

(C) Upon the exercise of conversion rights of convertible shares, the stated capital of the corporation shall be reduced if and to the extent that the express terms of such shares so provide;

(D) The stated capital of the corporation shall be reduced to the extent and in the manner that such reduction is provided for in an amendment to the articles described in paragraph (8) of division (B) of section 1701.69 of the Revised Code;

(E) The stated capital of a particular class of shares may also be reduced by resolution adopted at a meeting of shareholders held for such purpose, by the affirmative vote of the holders
of two-thirds of the shares of each class, regardless of limitations or restrictions in the articles on the voting rights of the shares of any such class, or, if the articles so provide or permit, a greater or lesser proportion, but not less than a majority of the shares of any class.

Nature and Development of Stated Capital

In the corporate laws of the various states, including Ohio, stated, or legal, capital is primarily a minimum amount of capital which serves as a limitation on the unrestricted distribution of assets to owners. Its basic function is to assure that some portion of the amount of assets contributed by stockholders will be held for protection of those dealing with the corporation. Although it stems from the consideration received upon issuance of shares, it is often an arbitrary amount, as discretion is generally granted to the boards of directors in setting the final amount of legal capital.

The origins of stated capital arose with the development of the corporation from a joint venture enterprise into a continuing economic unit. This change necessitated the making of a distinction between capital contributed by owners and income. Unlike the joint venture in which original capital plus any profits were returned to share owners at the end of each economic venture, the permanence of today's corporations gives rise to a need for preserving the capital invested by owners.¹

The concept of limited liability of owners developed as a counterpart to the idea that shareholder subscriptions to capital be dedicated to the risks of the enterprise.\(^2\) Since owners are liable only to the extent of their contributions, creditors can look only to the corporate assets for satisfaction of the amounts due them. In the corporate laws of today stated capital may be something less than the entire amount of shareholder contributions. It is, however, considered to be a substitute for unlimited personal liability of owners.\(^3\)

Thus at present, stated capital tends to represent an amount of assets which is to be retained in the business as long as the corporation exists. It frequently is an arbitrary amount set by the corporate management, and its chief function, from a legal standpoint, is to provide a margin of protection to creditors by restricting asset withdrawal by owners.

**Summary of Code Requirements Containing Accounting Implications**

Sections 1701.30 and 1701.31, relating to stated capital and the reduction of stated capital, contain the following points which are of significance from an accounting standpoint.

(A) Each class of shares is to have a stated capital and the stated capital of each share of a particular class outstanding at a particular time shall be identical.

\(^2\)Ibid., p. 14.

(B) The stated capital of the corporation shall be the aggregate stated capital of all classes of outstanding shares. The aggregate stated capital at no time shall be less than five hundred dollars.

(C) The stated capital of shares issued for cash or other property shall be the amount of consideration received, unless the directors (or others who fix the consideration) specify the portion of the total consideration that shall constitute stated capital. Any excess over this amount is capital surplus. Where an allocation to capital surplus is made:

(1) Stated capital of par value shares shall be not less than the par value.

(2) Stated capital of shares having a preference as to liquidation shall be not less than the lesser of (1) the entire consideration, or (2) the amount of the preference.

(D) The stated capital of shares issued upon conversion of obligations, conversion of shares, change of shares, or exchange of shares, shall be the same as the principal amount of the obligations converted, or the shares converted, changed, or exchanged, unless the terms of the conversion, or amendment to the articles, provides otherwise.

(E) The stated capital of shares to be outstanding at the time a merger, consolidation or reorganization becomes effective shall be the amount set forth or provided for in the agreement of consolidation or plan or reorganization.

(F) The stated capital of a class of outstanding shares, with or without par value, may be increased by:

(1) A transfer from any surplus however created to stated capital upon the order of the board of directors.

(2) Issuance of dividends in shares of the same class.

(G) The stated capital of a corporation cannot be reduced to an amount less than five hundred
dollars, or in the case of par value shares, to an amount less than the par value of the shares outstanding.

(H) The stated capital shall be reduced whenever shares are redeemed, purchased, or otherwise acquired, by an amount equal to the stated capital of the shares acquired.

(I) The stated capital of a particular class of shares may be reduced by resolution approved by the holders of two-thirds of the shares, regardless of limitations on voting rights.

Discussion

The Ohio Code has adopted the use of the term "Stated Capital" in place of "Capital Stock," in an attempt to avoid ambiguities as to the meaning of "Capital" and "Capital Stock." The latter term is generally found in accounting usage today and is considered to mean the same thing as legal or stated capital. One of the Committee members who was interviewed stated that he thought it would be desirable, although not mandatory, if accountants would adopt the use of the legal term. This would seem desirable in light of the significance of the legal concept of stated capital in corporate law. The recent revision of the Code (October, 1955) provides that each class of shares is to have a stated capital and that the stated capital of the corporation is to be the aggregate of the stated capital of all classes. In the former law stated capital was not attributable to individual classes of shares,

but rather was a single total amount. This change results in bringing legal and accounting concepts more closely together. Accountants have tended to view classes of stock as separate sources of corporate capital, with the totals of each class having significance beyond being merely components of an aggregate amount. Further, stated capital is now attributable to individual shares of each class so that pro-rata reductions for reacquired shares may be easily determined.

With respect to the determination of the amount of stated capital the revised law provides for essentially the same treatment for both par and no par shares: the stated capital shall be the amount of consideration received unless those authorizing the issue designate a portion of the total consideration as capital surplus. The law further provides, however, that the stated capital for par shares must be at least par value and that where shares have a liquidation preference, the stated capital must be equal to at least the lesser of the entire amount of consideration or the liquidation value.

It is in this area, the determination of the amount of stated capital, that the Ohio Code (and other state laws as well) set forth legal requirements which are in substantial disagreement with the views of accountants. The position that most accountants have taken is that the total amount of owner contributions should represent the basic permanent capital of the enterprise, i.e., the legal capital. Both the American Institute of Certified Public Accountants and the American Accounting
Association have set forth pronouncements that stockholder equities should be accounted for in terms of contributed, or paid-in, capital and earned capital. The American Institute of Certified Public Accountants, recognizing the existence of provisions in state laws permitting allocations to paid-in (capital) surplus, has stated that the contributed portion of proprietary capital should be shown as (1) capital contributed for, or assigned to, shares to the extent of par or stated value, (2) capital contributed for, or assigned to, shares in excess of par or stated value, and (3) capital received other than for shares, whether from shareholders or others. The American Accounting Association, on the other hand, has simply stated that stockholders' interest consists of paid-in capital and retained income, and that paid-in capital is measured by the cash, or fair market value of other assets or services, contributed by stockholders.

Thus, the position of accountants is that the most desirable method of accounting for the ownership interest is in terms of a basic distinction between contributed capital and earned capital, despite the fact that this is not always consistent with the facts from a strict legal viewpoint. For example, assume a situation in which shares have been issued at a price in excess of par value and par value represents the legal capital of the

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enterprise. A disclosure, such as that which follows, might well be misleading to anyone not aware of the legal implications of such terms as "capital contributions in excess of par value," "paid-in, or capital, surplus," or "premium on capital stock."

Stockholders' Equity
Paid-in Capital
Capital Stock $100,000
Capital Contributed in Excess of Par Value 10,000
Total Paid-In Capital $110,000
Earned Surplus XXX
Total Stockholders' Equity XXX

Normally the earned surplus account (retained earnings) is viewed as being the measure of the maximum amount of assets which may be legally distributed as dividends. In the above situation the amount paid in excess of par value, regardless of the name given it, is legally available for dividends. This criticism does not mean that the accountants' position is necessarily wrong. To the contrary, it would appear that their viewpoint might well be the sounder of the two. However, in light of the present legal requirements the adherence to practices such as this can be misleading unless there is adequate disclosure, by parenthetical note or otherwise, as to the facts as they exist in terms of the law.

The practice of permitting the designation of something less than the entire consideration as stated capital, and thereby creating a capital surplus, represents a departure from the earlier philosophy as to legal capital and restrictions as to dividend payments. In the Ohio statutes prior to 1927 there
were explicit restrictions on the payment of dividends from any
sources other than profits and by implication a definite dis-
tinction between invested and earned capital.\(^7\)

In regard to the provision of the law permitting the allo-
cation of a portion of shareholder contributions to paid-in surplus,
the 1926 Committee stated:

Various purposes may be served by the creation of
a paid-in surplus. A corporation may require cash
over and beyond its capital to get its business un-
der way or to provide a fund to meet possible losses
or to stabilize the payment of dividends.\(^8\)

Since this provision is still carried in the law today it may be
presumed that the purposes envisioned in 1926 are still available
today. The use of paid-in surplus in this fashion may be desir-
able from the standpoint of financial management, but it is un-
desirable as a matter of public policy. The absorption of oper-
ating losses is obviously contrary to what would ordinarily be
considered appropriate accounting practice as such a procedure
would completely destroy the significance and integrity of the
earned surplus account. The purpose of stated capital is to
serve as a limitation on withdrawals which might be to the prej-
udice of either creditors or holders of senior securities. How-
ever, this purpose is easily defeated where a paid-in surplus,
which is freely available for dividends, share purchases, and
absorption of losses, may be created by the use of low par and

\(^7\) Davies, Corporations, pp. 633-638.

\(^8\) Committee Report (1926), p. 91.
no par shares. The fact that the law requires notification to stockholders as to source, where dividends are paid from capital surplus, by no means rectifies the basic imperfection in this provision of the Code.

It should be noted that in the recent revision of the Ohio law there is a presumption that the entire consideration received upon issue of shares is to be considered as the corporate legal capital. The defect still exists in the law by virtue of the permission to make an allocation. However, the fact that the entire consideration will become stated capital, unless specific action is taken, seems to be a desirable change in the law.

With regard to par value shares the Code states that stated capital must be at least the par value, and further, that such shares must be issued for an amount at least equal to the par value. This prohibition against the issuance of shares at a discount would appear to preserve the integrity of the concept of stated capital in so far as par value shares are concerned. However, the fact that the minimum capital requirement is only $500 permits the creation of a sizable paid-in surplus (through the use of low par shares and a liberal allocation to surplus), thereby affording but little protection to creditors.

Accountants have traditionally given effect to the issuance of par shares at an amount in excess of par value by the use of separate accounts for the premiums involved. Thus if a share

9Davies, Corporations, p. 626.
having a par value of $50 were issued for $60, it would be recorded by the following entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>$50</td>
</tr>
<tr>
<td>Premium on Capital Stock</td>
<td>10</td>
</tr>
</tbody>
</table>

Under the revised Code, if there were no allocation to capital surplus, then the entire amount of the consideration would become the stated capital. It was the opinion of the Committee members interviewed that the intent of the law was that the capital stock account should always reflect the stated capital of the corporation. The entry then, consistent with the revised law, would be:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>$60</td>
</tr>
</tbody>
</table>

If there were an allocation to capital surplus and the stated capital designated as $50, then the entry to record would be:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>$50</td>
</tr>
<tr>
<td>Capital Surplus</td>
<td>10</td>
</tr>
</tbody>
</table>

Although the law now uses the term "capital surplus" exclusively, the Committee members felt that account titles other than that might be used, provided there was a clear disclosure as to the nature of the items involved and the amount of stated capital.

The provisions of the revised law with regard to shares having a liquidation preference affords a greater degree of protection to those shareholders than was available to them under the old law. Since the new requirements result in a larger minimum stated capital, it is of advantage to creditors as well.
The Code now requires that the stated capital must be an amount equal to at least the lesser of: (1) The entire amount of the consideration, or (2) the amount of the liquidation preference. To illustrate, assume the issuance of preferred shares having a par value of $50 and an involuntary liquidation value of $60. If the stock were issued at $75, the transaction might be recorded by either of the following entries, depending upon the action of the board of directors with respect to an allocation to surplus.

1. Cash $75
   Capital Stock $75

2. Cash $75
   Capital Stock $60
   Capital Surplus 15

Under the former law par shares always had a stated capital equal to par value, regardless of the amount of the liquidation preference or the issue price of the shares. Thus in the above situation the stated capital would have been $50 and capital surplus $25.

The contrast might be even more marked in the case of a no par preferred. If shares without par value were sold for $95 and they had a liquidation preference of $100, the stated capital would have to be at least $95. Under the old law any part of the $95 consideration might have been allocated to capital surplus.

The provisions of the law relating to the stated capital of shares issued as a result of conversion, change, or exchange of shares are designed to maintain the aggregate stated capital at an amount which represents the capital originally paid for, or
assigned to, shares. The Code states that the stated capital of the new shares issued shall be the same amount of the old shares which are being replaced. In this fashion the diversion of capital, to the detriment of creditors or shareholders, is prevented.

Writers in the field of accounting, in an attempt to generalize as to the legal requirements to the various state laws, have generally tended to reflect in the capital stock account the par or stated value of shares. Under some circumstances, this practice may result in a reduction of legal capital and a consequent diversion of equity from one class of shareholders to another.

To illustrate, the following example is taken from Karrenbrock and Simons: 10 10,000 shares of preferred stock which has a par value of $100 per share and which was originally issued at a premium of $10 per share, is converted into 3,000 shares of common stock which has a stated value of $25 per share. The entry set forth to record the conversion is as follows:

Preferred stock $100,000
Premium on preferred stock 10,000
Common stock $75,000
Paid-in surplus

As a result of the above entry there is a reduction of $25,000 in the aggregate legal capital of the enterprise. Under

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the Ohio Code the transaction would be recorded so that the capital stock account (stated capital) would be credited with $100,000 and paid-in surplus with only $10,000, and thereby preserving the stated capital at an amount equal to that which existed prior to the conversion. Under the Ohio law prior to the 1955 revision, the principles outlined in the above text book illustration would have been applicable to par value shares. The Code at that time required that the stated capital of par shares be equivalent to par value, and as a result, if shares of a lesser par value were issued upon conversion, change or exchange, there would have been an automatic reduction in legal capital. Thus the recent revision of the Code has resulted in an improvement of the law, requiring a greater minimum stated capital than it formerly did.

With regard to convertible obligations, the Code provides that upon conversion the stated capital is to be increased (for the shares issued) by an amount equal to the face amount of the debt converted. This provision results in the assignment to capital of an amount essentially equivalent to the assets originally acquired by the corporation at the time the debt was incurred. Where the present value of the debt is something other than principal amount (due to an unamortized balance of bond premium or discount) at date of conversion, the result is an addition to stated capital which is slightly more or less than the amount of original asset acquisition.

Accountants generally have set forth two possibilities for handling transactions of this type. The first is based upon the
amount of the debt (but with a credit to the capital stock account of only the par or stated value and the excess, if any, to paid-in surplus), and the second is based upon the market value of the shares at the time of the conversion. To illustrate, assume that bonds having a face value of $10,000 are convertible into 100 shares of common stock having currently a stated capital of $75 per share and a market value of $104 per share. The first entry that follows records the conversion on the basis of the face amount of the debt and the second on the basis of the market value of the shares.

(1) Bonds Payable $10,000
    Capital Stock $7,500
    Paid-in Surplus 2,500

(2) Bonds Payable $10,000
    Earned Surplus 400
    Capital Stock $7,500
    Paid-in Surplus 2,900

Under the revised Ohio Code stated capital would have to be increased by an amount equal to the debt. Therefore, the entry to record the conversion would be:

Bonds Payable $10,000
    Capital Stock $10,000

Where shares are convertible into other shares having an aggregate par value in excess of the aggregate stated capital of the convertible shares, the corporation must have a surplus, 

11 The first method seems to have received the most usage and widespread acceptance among accountants according to C. A. Moyer and R. K. Mautz, Functional Accounting (New York: John Wiley and Sons, Inc., 1951), pp. 317-319.
at time of issuance of the convertible shares, at least equal to the excess. Further, during the period of conversion the corporation must reserve from surplus an amount equal to this excess so that as shares are converted transfers may be made to stated capital. The Code contains similar provisions as to reservation of surplus and transfer to stated capital where debt securities are convertible into par shares having an aggregate par value which is greater than the aggregate principal amount of the debt.

Accounting theory is consistent with these provisions, recognizing an increase in legal capital. However, where the Code uses the term "surplus," meaning anything other than stated capital, accounting theory makes the qualification that the charge for the excess amount should be made to earned surplus.

Authority is provided in the Ohio law for the stated capital of any class of shares to be increased, at the discretion of the board of directors, by either a simple transfer from surplus or the issuance of dividends in shares of the same class. Discussion of this provision for surplus capitalization is deferred until Chapter III, in which consideration is given to share dividends along with cash and property dividends.

A significant change was made in the Ohio act in 1955 with

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12RC, Sec. 1701.21 (conversion of shares).
13RC, Sec. 1701.22 (conversion rights).
respect to stated capital upon the reacquisition of shares. As a result of the revision, stated capital is automatically reduced at the time shares are reacquired by an amount equal to the stated capital of the shares involved. The stated capital of shares outstanding at any time may be determined merely by dividing the total stated capital by the number of shares outstanding. The revised law provides that each share outstanding at a particular time shall have the same stated value regardless of issue price. Thus if 100 shares were issued at $50 per share and another 100 shares were issued at $60 per share (and in each instance stated capital was equal to the issue price), the corporate stated capital would be reduced by $55 per share upon the reacquisition of any of these shares. Under the former law stated capital was reduced only when redeemable shares were purchased. The acquisition of treasury shares had no effect on stated capital until the board of directors took action to retire them. At that time stated capital would be reduced. Further considerations of accounting for treasury shares are set forth in Chapter V.

Aside from the reacquisition of shares, stated capital can be reduced only by the approval of two-thirds of the shareholders of each class. This provision is the authority for corporations to undergo a quasi-reorganization while at the same time, it provides a measure of control by virtue of the stockholder.

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15 The Code provides that shareholders includes subscribers to shares and that subscribed shares are deemed to be outstanding shares. See RC, Sec. 1701.01 (definitions).
approval requirement. The matter of quasi-reorganization involv­
ing restatements of owner equities, both capital and surplus, is discussed in connection with surplus in Chapter III.

The Ohio Act does not specifically provide a means for achiev­
ing a general contraction of capital in instances where it is de­
sired to reduce the scale of corporate activities. This may be accomplished, however, by the purchase and subsequent retirement of treasury shares.

The Code provides a general limitation to reductions of stated capital by the requirement that the aggregate stated capital can be no less than $500 and must be at least equal to the aggregate par value where par shares are involved. The $500 limitation permits an extremely thin capitalization and when coupled with the possibility of share changes to low par or no par shares, the potential for equity adjustments to the detri­ment of creditors exists. However, the law does provide indirect limitations by provisions as to unlawful distributions and dis­tributions which would create insolvency, and a direct limi­tation with respect to share reacquisitions. The latter limi­tation is discussed in Chapter V which is concerned with share acquisitions.

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16 RC, Sec. 1701.95 (unlawful loans, dividends, distributions of assets; also Sec. 1701.33 (dividends). Sec. 1701.01 (defi­nitions) states that insolvent means the corporation is unable to pay its obligations as they become due in the usual course of affairs.

17 RC, 1701.35 (purchase of own shares by a corporation).
Evaluation

It would be desirable if the Code stated explicitly that the capital stock account is always to reflect the stated capital of the corporation, and further, that the corporation always set forth and identify the amount of stated capital by class of shares and in total. The provisions attributing stated capital to classes of shares and thus making possible the determination of the stated capital of individual shares by division of the total by the number of shares outstanding are most desirable. The assignment of the same stated capital to each share outstanding at a particular time facilitates the accountant's task in transactions involving reacquisitions of shares and in addition is theoretically sound. Shareholders contribute assets to the corporation on the premise that they are acquiring shares in the total asset value of the enterprise. Some owners may contribute a greater or lesser amount per share than others, but after issue one share is like any other from both an economic and legal standpoint.

Insofar as the amount of legal capital is concerned accountants have a somewhat different objective than does the law. Accountants are interested in maintaining a primary distinction between invested capital and earnings, whereas the law is concerned with distinguishing between legal capital and surplus. The point of view of the law stems from the fact that legal, or stated capital basically is an arbitrary amount. It would appear that the accountant's viewpoint (which is consistent with earlier laws and charters) of distinguishing between contributed
and earned capital is the most desirable means of determining an amount to serve as a limitation upon asset distributions to stockholders. The provision in the present law in Ohio permitting the creation of a capital surplus from owner contributions falls short of providing the maximum reasonable protection to creditors and senior shareholders. Further, the failure to restrict dividend payments to the amount of earned surplus is inconsistent with the usual concept that dividends represent a distribution of earnings and that original invested capital is to be preserved.

The requirements relating to the stated capital of par value shares and shares having a liquidation preference are desirable in light of the present provisions as to legal capital. However, undesirable practices resulting in diversion of equity from one class of shareholders to another are available to some extent despite these requirements. Prohibiting the allocation of share consideration to capital surplus would eliminate these possibilities.

The Code sets forth sound provisions in regard to conversion, change, and exchange of shares. It recognizes that replacing one type or class of shares with another should have no effect on the aggregate stated capital where there are no concurrent changes in asset values. The preservation of the amount of capital originally assigned to shares at least continues the same degree of protection to creditor equities as existed prior to the change. The recent revision of the law to allow a stated capital in excess of par value is desirable in that it permits the
assignment of the entire amount of shareholder contributions to stated capital. In addition, it provides a means, in the case of par shares, for the application of the above rule that the stated capital of shares issued upon conversion, change, or exchange shall be the same as the original shares.

In a similar fashion the law contains sound requirements as to the treatment of convertible obligations, providing that the stated capital of shares issued upon conversion shall be the same as the face amount of the debt. As a result the amount of the original investment of assets in the enterprise is transferred from a creditor equity to an owner equity. The proposal set forth by some accountants that the new shares be capitalized at their market value is desirable in that it might provide a greater amount of legal capital. However, this practice involves the arbitrary capitalization of surplus, and further, is predicated upon the little used assumption that market values of shares are directly related to the book values of the equities.

The treatment accorded the conversion of securities (either shares or debt) in situations resulting in an increased stated capital is desirable and consistent with the philosophy set forth in the sections of the Code which state the general rules regarding conversions. The provision allowing the capitalization of any surplus for the increased amount of legal capital is reasonable in light of the present law permitting the creation of capital surplus accounts. The accountants' general position is that such a charge should be made to earned surplus if it represents
an amount in excess of the original contribution. This viewpoint stems from their attempts to account for owner contributions as a unit and without any regard for the legal distinction between stated capital and capital surplus.

The restrictions imposed by the Code upon the reduction of stated capital are in general desirable as far as they go. However, the fact that stated capital can be reduced to create a capital surplus (which in turn can represent the measure of distributable assets), opens the way for financial practices which are detrimental to the position of creditors. The elimination of the distributable capital surplus feature of the law would do much to eliminate possible equity abuses. The law should of course retain the possibility of effecting reductions, upon the approval of the equity interests involved, such as those which are required in a quasi-reorganization. The requirement that stated capital be reduced upon the reacquisition of shares is sound. However, it would be desirable if there were stronger limitations upon the extent to which treasury shares can be acquired. These limitations will be discussed in Chapter V, which considers share acquisitions.
Chapter III

Surplus

Legal Requirements

The provisions of the Ohio General Corporation Act relating to earned and capital surplus\(^1\) are set forth below:

(A) The surplus of a corporation is the excess of its assets over its liabilities plus stated capital. The earned surplus of a corporation is the net balance of its net profits, income, gains, and losses from the date of incorporation (except as otherwise provided in the agreement of merger or consolidation in the case of the surviving or new corporation in a merger or consolidation), or from the latest date on which a deficit in earned surplus was eliminated by application of capital surplus or otherwise, after deducting distributions to shareholders and transfers to stated capital and capital surplus to the extent that such distributions and transfers are made out of earned surplus. Undistributed earned surplus of a corporation all or some of whose shares are owned by another corporation does not constitute earned surplus of such other corporation. Surplus other than earned surplus is capital surplus. Profit and gains from transactions in shares of the corporation do not constitute a part of earned surplus; losses from such transactions may be charged against capital surplus resulting from profit and gains from such transactions, and any balance of losses shall be charged against earned surplus.

(B) Capital surplus shall be classified according to its derivation and shall be so shown on the books of the corporation, and each balance sheet shall show separately any capital surplus arising from unrealized appreciation of assets, (and) other capital surplus, and earned surplus.

(C) A voluntary contribution to a corporation of property other than shares of the corporation,

\(^1\)RC, Sec. 1701.32 (surplus).
accepted by the directors, shall constitute capital surplus. The fair value to a corporation of a contribution of property other than shares of the corporation shall be determined by the directors.

(D) Whenever the directors are of the opinion that physical assets of a corporation have a fair value to it in excess of the amount at which they are carried on its books, and shall determine the amount of such fair value, they may order all or a part of the fair value so determined to be entered on its books and thereby create or add to capital surplus of the corporation. Nothing in this section shall be deemed to prevent a corporation which owns shares in another corporation, domestic or foreign, from carrying such shares on its books at the value thereof as shown on the books of the issuing corporation, if the corporation owning such shares believes in good faith that the books of the issuing corporation are kept in accordance with sound accounting practice; and thereby the corporation owning such shares may create or add to capital surplus of such corporation; in case a corporation carries shares on such basis, its balance sheets shall contain a statement to that effect.

(E) The directors may order transfers from any surplus however created to stated capital of shares with or without par value, and from earned surplus to capital surplus.

(F) Pursuant to resolution adopted by the affirmative vote of the holders of two-thirds of the shares of each class, regardless of limitations or restrictions in the articles on the voting rights of the shares of any such class or, if the articles so provide or permit, a greater or lesser proportion, but not less than a majority, of the shares of any class, a corporation may apply all or any part of capital surplus, excepting only surplus arising from unrealized appreciation of assets, to the reduction or writing off of any deficit in earned surplus, or to the creation of a reserve for any proper purpose, and thereby make available for dividends, without notice to the shareholders as to the source of such dividends, any earned surplus remaining, or thereafter arising, but in case
such action is taken, a record thereof shall be made on the books of the corporation and shall appear on each balance sheet of the corporation for a period of not less than five years thereafter.

Nature of Surplus

The term "surplus," as used in both legal and accounting literature, represents a measurement of the recorded excess of asset values over the capital (asset) contributions assigned to shares. It has been variously defined, but in general the explanations as to its meaning have been quite similar. The following statements are illustrative of the definitions found in the writings of both fields. In a court case it was held that "The surplus account represents the net assets of a corporation in excess of all liabilities including capital stock."² Karrenbrock and Simons state "The amount by which the total corporate capital exceeds legal capital or the capital stock element is known as surplus."³ Moyer and Mautz state that "Surplus is the term used to designate the excess of assets over liabilities and capital stock."⁴ The Ohio Corporate Code definition, taken principally from the new Wisconsin Act,⁵ states that "The surplus

⁵Committee Report (1955), p. 54.
of a corporation is the excess of its assets over its liabilities plus stated capital.\^6

Accountants generally have been more concerned with identifying the components of surplus rather than the aggregate amount. Accordingly they have striven to classify surplus as to source and thereby disclose the origins of shareholder equity. The American Institute of Certified Public Accountants has stated that capital surplus represents capital contributed for shares in excess of their par value, or capital contributed other than for shares, and that earned surplus represents accumulated income or the remainder thereof at the balance sheet date.\^7 Other classifications which might be used to denote the nature of surplus items are: paid-in surplus, surplus arising from revaluation of assets, other capital surplus, and earned surplus.\^8

In a similar fashion the courts and state codes have come to distinguish between earned surplus and other classes of surplus such as those arising from donation of assets, revaluation of assets, and contributions of assets in excess of legal capital.

\^6\textit{Supra}, p. 30.
\^7\textit{Committee on Terminology, Terminology Bulletins, No. 1} (New York: American Institute of Certified Public Accountants, 1953), p. 29. It should be noted that this body has also recommended the discontinuance of the term "surplus," and the substitution of descriptive phrases as "retained income" and "capital contributed in excess of par value." However, this change of terminology in no way negates the basic distinctions as to source of these equity items.
\^8This classification is required for reports filed under Regulation S-X. \textit{Securities and Exchange Commission, Accounting Series Release No. 70} (1950).
Although the wording and terminology differ at times from that of the accountant, it appears that the legal understanding of the nature of surplus is substantially that of the accountant.  

Summary of Code Requirements Relating to Surplus

Section 1701.32, relating to the surplus of corporations, contains the following provisions and definitions which are significant from an accounting standpoint:

(A) The surplus of a corporation is the excess of its assets over its liabilities plus stated capital.

(B) Earned surplus is the net balance of net profits, income, gains, and losses, after deducting distributions to shareholders and transfers to stated capital and capital surplus. It represents an accumulation from date of incorporation or date at which a deficit has been eliminated by capital readjustment. An exception is in the case of merger or consolidation, in which the agreement may provide otherwise.

(1) Earned surplus does not include the earned surplus of another corporation whose shares are owned as an investment.

(2) Profits and gains from transactions in a corporation's own shares do not constitute a part of earned surplus.

(3) Losses from transactions in a corporation's own shares may be charged against capital surplus resulting from profits and gains in these transactions, and any balance of losses shall be charged against earned surplus.

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(C) Capital surplus is any surplus other than earned surplus.

(1) The accounting records of the corporation must reflect capital surplus classified according to its derivation.

(2) Voluntary contributions of property other than shares of the corporation constitute capital surplus. The fair value of such contributions shall be determined by the board of directors.

(3) When, in the opinion of the board of directors, the physical assets of the corporation have a fair value in excess of their recorded amounts, all or part of the fair value may be entered on the books and thereby create additional capital surplus.

(4) A corporation owning shares of another corporation may carry those shares on its books at the value shown on the books of the issuer, and thereby create or add to capital surplus. Where shares are carried on this basis the corporation's balance sheet must contain a statement to this effect. The only limitation to the adoption of this practice is that the corporation owning the shares must believe in good faith that the books of the issuer are kept in accordance with sound accounting practice.

(D) The corporate balance sheet must show separately any capital surplus arising from unrealized appreciation of assets, other capital surplus, and earned surplus.

(E) The directors may order transfers from any surplus, however created, to the stated capital of shares with or without par value. They may also order transfers from earned surplus to capital surplus.

(F) With the approval of two-thirds of the shareholders of each class, a corporation may apply all or part of capital surplus (other than that arising from unrealized appreciation) to the reduction or writing off of any deficit in earned surplus, or to the creation of a reserve for any proper purpose, and thereby
make available for dividends, without notice as to source, any earned surplus remaining or thereafter arising. Where such action is taken a statement must appear on the balance sheet for a period of not less than five years.

Discussion

Section 1701.32 is a new section which relates exclusively to surplus, attempting to define precisely what the law intends the term "surplus" to mean. Prior to the 1953 revision the provisions concerned with paid-in surplus were in a separate section and other surplus provisions were set forth as a part of the section on dividends. The new law has substituted a broader term, "capital surplus," in place of "paid-in surplus." The other terminology remains substantially the same as that contained in the older statutes.

The Code defines the surplus of a corporation as being the excess of its assets over its liabilities plus stated capital. As a further refinement earned surplus is described as the balance of net profits, income, gains and losses, after deductions for distributions to shareholders and transfers to other capital accounts. Capital surplus, according to the revised law, is a generic term representing any surplus other than earned surplus.

The definition of surplus (where unqualified as to type) is in substantial agreement with general legal and accounting usage.\textsuperscript{10} A more explicit explanation, indicating clearly the

\textsuperscript{10}Supra, p. 32.
nature of surplus, would express the definition in terms of measuring and accounting for a portion of the total asset values. Fundamentally, the equities, both creditor and owner, represent sources from which corporate capital is obtained. The liabilities represent a measurement of the amount of assets obtained from creditors and the capital stock a measurement of the amount of assets obtained from owners and assigned to stated capital. In a similar fashion surplus is a measurement of the amount of asset values obtained from other sources, whether from operating activities (earned surplus), from owners (contributions assigned to paid-in surplus), or origins such as asset donations or asset revaluations.

The Code definition of earned surplus follows almost word for word the definition proposed by the American Institute of Certified Public Accountants. The American Accounting Association has made a similar pronouncement. Substituting the term "retained income" for "earned surplus," it has stated "Retained income is the amount of income since the formation or reorganization of the enterprise less the amount distributed to stockholders."

The definition of capital surplus as being any surplus other than earned surplus is inconsistent with the views of many accountants in so far as the choice of terminology is concerned. However,

11 Committee on Terminology, op. cit., p. 16.
the further distinction that the Code draws between earned surplus
and capital surplus, and the requirement that capital surplus be
classified according to derivation, is in agreement with the po-
sition that accountants take. For many years accountants have
thought that it is important to account for the ownership equity
in terms of origin, with particular emphasis on an accurate state-
ment of earned surplus. This importance attached to earned
surplus arises from the fact that it is viewed as a reflection of
the capital growth and expansion which has been accomplished
through earnings, and the other surplus items are either better
omitted from the balance sheet (such as surplus from asset ap-
praisal) or properly belong to the permanent capital fund.

As a result of a recent trend to more descriptive termin-
ology, accountants have come to advocate the discontinuance of
the term "surplus," whether used alone or in connection with a
qualifying word such as "capital surplus." Most members of the
accounting profession would consider the adoption of the term
"capital surplus" in place of the more definitive words "paid-
in surplus" (as was used in the old law) to be a step in the
wrong direction. Although the latter phrase uses the word "sur-
plus," it at least has the quality of denoting something of the
derivation and nature of the surplus.

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In addition to defining earned surplus in terms of the types of transactions which affect it (profits, income, gains, losses, distributions and transfers), the Code states explicitly that neither the earned surplus of corporations whose shares are owned as an investment nor "gains" arising from transactions in the corporation's own shares are to be included as a part of earned surplus. "Losses" in excess of "gains" in share transactions are chargeable to earned surplus. With the exception of the treatment accorded losses, both of these provisions are consistent with generally accepted accounting theory.

The Committee members who were interviewed stated that the first exclusion would by no means bar the preparation of consolidated financial statements. The intent of the provision is to prohibit a company owning shares of another company from recording on its books as a credit to earned surplus any part of the undistributed profits of the latter. Valuation of shares on a basis higher than cost gives rise only to a capital surplus under the Ohio law. The preparation of a consolidated balance sheet is considered to be a group reporting device and that there should be no prohibition to combining the earned surplus accounts, after appropriate adjustment, into a consolidated surplus figure. However, the fact that such a surplus does not represent the measure of legally distributable assets should be disclosed. Consolidated statements are discussed further in Chapter VI.

The second exclusion, relating to transactions in a company's own shares, is essentially compatible with the views of accountants.
This matter is discussed further in Chapter V in connection with reacquired shares.

The requirement contained in the Code that the books of the corporation must reflect capital surplus according to derivation is to provide a means for complying with certain dividend restrictions. Under the Ohio Code cash and property dividends based upon unrealized appreciation are prohibited, and dividends measured by surplus other than that arising from earnings requires notice as to source. These limitations are considered more fully in Chapter IV relating to the dividend provisions of the law.

The revised statute contains a new provision in the form of an explicit statement that voluntary contributions of property other than shares constitute capital surplus. The purpose of this provision, according to the drafting Committee, is to settle the question as to the accounting treatment to be given such contributions. It points out that sometimes the expression "capital contributions" is used, but as far as the Ohio Code is concerned, they are to be a part of capital surplus. Accountants would have no disagreement with the Committee viewpoint as to the nature of such contributions, but they might prefer to describe it when reporting with a phrase such as "capital contributions acquired by donation" or other terminology describing it as a capital contribution received other than for shares issued. The matter

15 RC, Sec. 1701.33 (dividends).
of reporting and disclosure under the Ohio law is taken up in Chapter VII.

The use of fair value for recording contributions of property is consistent with accounting practice. The American Accounting Association has stated that "Where an asset is acquired from investors or donors its cost for accounting purposes is fair market value at the time of acquisition."\(^{17}\)

It should be noted that where the Code uses the phrase "voluntary contributions of property other than shares . . . constitute capital surplus," it does not infer that donation of shares gives rise to something other than capital surplus. One of the Committee members indicated that this provision was intended to relate only to property. The treatment of such share acquisitions is covered in Section 1701.31, which provides that stated capital is to be reduced when shares are purchased or otherwise acquired. Where there is no corresponding reduction in asset value, then the amount of stated capital assigned to the shares would be transferred to capital surplus.

The Ohio Code provides two devices by which unrealized appreciation may be recorded on the books of a corporation. In each case it designates specifically that the equity established is a capital surplus item.

The first instance is a provision permitting the write-up of physical assets where, in the opinion of the board of directors,

\(^{17}\)Committee on Concepts and Standards, \textit{op. cit.}, p. 2.
the fair value of the assets exceeds the recorded amounts. The Code states that in such a situation all or part of the fair value may be entered on the books of the company and thereby create or add to capital surplus. There is no statement, however, as to the ultimate disposition of such a capital surplus other than by share dividends. The Committee members interviewed stated that write-downs of asset values against capital surplus were not intended. However, the gradual elimination of such a surplus by entries in connection with depreciation would not be prohibited. This seems to be one of the several sections in the Code in which a definitive statement is omitted and the final answer is left to the accountant.

In the recent revision of the law the write-up of assets to their fair value is restricted to physical assets. The former law permitted writing up patents and goodwill as well as other classes of assets. This change, particularly as it relates to goodwill, seems most desirable. One of the Committee members stated in the interview that he thought that this entire section was unsound and that asset write-ups should not be permitted. This viewpoint is shared by many accountants who believe that the assignment of non-objectively determined asset values should be prohibited. It might be noted that this provision was

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18 RC, Sec. 1701.31 (dividends).
19 Committee on Accounting Procedure, Accounting Research Bulletin No. 43 (New York: American Institute of Certified Public Accountants, 1953), p. 68; also Committee on Concepts and Standards, op. cit., p. 2. In recent years many accountants have
enacted in the 1927 Code "to correct the vice of declaring (cash) dividends out of unrealized profits" by requiring segregation of unrealized surplus from earned surplus.\(^\text{20}\) The Committee apparently did not feel disposed to correct the abuse by prohibiting the creation of such a surplus.

The second provision permitting the recording of unrealized appreciation relates to the valuation which may be assigned to shares which a corporation owns in another corporation. The Code states that such shares may be carried on the books of the company owning them at the value shown on the books of the issuer, providing the holder believes in good faith that the books of the issuer are kept in accordance with sound accounting principles. A further stipulation requires that there be a disclosure on the balance sheet where this method is adopted.

This feature of the law is new and represents a modification of the rule restricting write-ups of assets. Only physical assets may be written up to their current fair value. Investment shares may be written up, not to their fair value, but to their book value as shown on the records of the issuer. The purpose of this provision appears to be permission to use the "actual" value or equity method of share valuation, while at the same time maintaining a consistency with regard to distinguishing between realized

\(^{20}\) Committee Report (1926), p. 91.

felt that it would be desirable if accounting technique gave effect to price level changes. This committee of the American Accounting Association has stated that they believe at this time price level changes should be reported only by means of supplementary statements. See Price Level Changes and Financial Statements (American Accounting Association, 1951), p. 11.
(earned) and unrealized surplus. The use of this method is available without regard to the proportion of total ownership represented by the investment shares. Accountants would generally feel that the adoption of this method should be restricted to situations in which a majority of outstanding shares were owned and operations were integrated.

The equity method of accounting for investment shares is based upon the premise that it is appropriate to reflect the gains and losses in the assets of a controlled subsidiary company as adjustments to the original cost of the shares. Thus a proportionate amount of subsidiary profits and losses are recorded as income or loss to the company holding the shares and ultimately become a part of its earned surplus. The application of this method, as described above, would not be permitted under the Ohio law, as changes in the book value of investment shares must be reflected as capital surplus. For some years many accountants have felt that the so called "actual value" method of share valuation is an undesirable departure from the general principle of establishing and maintaining asset values on a cost basis.21

From the standpoint of the parent company balance sheet alone,

the Code requirement is sound and in the public interest, as it prohibits an inflation of earned surplus with unrealized profits. This is not to say, however, that the accountants' consolidated balance sheet, reflecting an entity concept, is undesirable. In the latter case the subsidiary assets and liabilities are substituted in place of the parent's investment in shares, thus presenting a combined picture of the companies. The entity concept and consolidated reports are discussed further in Chapter VI.

The choice of wording in this section is unfortunate as its lack of explicitness creates confusion as to the intent of the law. It grants only a definite permission to write-up investment shares "and thereby create or add to capital surplus." No mention is made of downward revaluations. The members of the Committee who were interviewed stated they felt the intent was that shares would be reduced as well as increased in value, reflecting at all times the investment at the book value of the issuer. Write-downs would be made against the capital surplus initially created to the extent of such surplus, and thereafter against earned surplus.

A further source of confusion lies in the use of the general term "capital surplus." Although the law requires classification of capital surplus as to derivation, and imposes restrictions upon basing dividend payments on unrealized surplus, it uses "capital surplus" as a generic term throughout the various sections. For example, "capital surplus" is used to describe the unrealized appreciation surplus created by writing up assets.
The same term is used with respect to the surplus created by the allocation of consideration upon issuance of shares. The use of a single term to describe two surplus items which are so different makes compliance with the Code difficult and leads to possible misconceptions. In light of the present law, with this provision for creation of unrealized surplus, it would be desirable if the language of the Code clearly distinguished between the classes of surplus. Actually, no very sound purpose is served by the inclusion of this section in the law, and further, definite possibilities for abuse exist through overvaluation of the assets.

The provisions permitting the board of directors to effect transfers from any surplus account to stated capital and from earned surplus to capital surplus represent a less restrictive rule than was contained in the former law. In the former law transfers were permitted from any surplus to stated capital, but only in support of share dividends. If the dividend were in shares having par value, then the amount transferred would have to be equivalent to the aggregate par value of the shares. Under the revised law transfers from surplus to stated capital may be effected in an amount greater than par value or in any amount which will maintain the stated capital at a figure equivalent to at least the par value of the shares outstanding. Further, transfers may now be made from earned surplus to capital surplus. These new provisions were written into the Code to facilitate compliance with the New York Stock Exchange rules relating to
stock dividends. Dividends in shares are considered further in conjunction with other dividends in Chapter IV.

With regard to the application of capital surplus to a deficit in earned surplus, as a part of a quasi-reorganization, the provisions of the revised Code are not consistent with the views of accountants. However, the recent changes represent an improvement. Formerly the authority for transferring capital surplus to a deficit was vested in the board of directors alone and disclosure of such a procedure was required only in the next annual report. Under the new law a corporation may take such action only upon the approval of at least two-thirds of the shareholders of each class, and disclosure is required on the balance sheet for a period of not less than the five years following.

The present wording of the Code provides that after shareholder approval:

A corporation may apply all or any part of capital surplus, excepting only surplus arising from unrealized appreciation of assets, to the reduction or writing off of any deficit in earned surplus, or to the creation of a reserve for any proper purpose, and thereby make available for dividends, without notice to the shareholders as to the source of such dividends, any earned surplus remaining, or thereafter arising, but in case such action is taken, a record thereof shall be made on the books of the corporation and shall appear on each balance sheet of the corporation for a period of not less than five years thereafter.

This provision was originally enacted in 1931, and except for minor changes remains essentially the same today. The 1931

\[22\text{Committee Report (1955), p. 54.}\]
law used the term "paid-in surplus" rather than "capital surplus," and in addition to granting authority to write off a deficit or create a reserve, had another provision permitting the "writing off of any particular loss or expense." The intent of the law, as expressed by the drafting committee at that time, was clearly stated by the following comment:

If this proposal is adopted, the directors may clear a deficit in the earned surplus account through the use of paid-in surplus or they may charge losses and expenses to such surplus or they may set up reserves and charge them to such surplus, provided a disclosure of such action is made to the shareholders in the next annual report.23

The Code provisions, as they stood during the period between 1931 and 1955, permitted corporations to undertake equity adjustments which are considered by the accounting profession to be improper. The general position of accountants, as stated by the American Institute of Certified Public Accountants, is that capital surplus should not be used to relieve the income account of charges which should be made thereagainst. An exception, however, is permitted under the rules relating to corporate readjustment or quasi-reorganization. In the latter case, upon approval of stockholders and after exhaustion of earned surplus, such charges may be made against capital surplus.24 Where a deficit exists in earned surplus, capital surplus may be used to absorb the debit

23 Committee Report (1930), p. 16.
24 Committee on Accounting Procedure, op. cit., pp. 45-47; a similar position has been taken by the Securities and Exchange Commission. See Accounting Series Release No. 1 (1937), and Accounting Series Release No. 25 (1941).
balance. In no case, however, should there remain any balance in earned surplus after charges have been made against capital surplus.

The permission to create a reserve out of capital surplus is at variance with accepted accounting procedure if the reserve so created is intended to be a surplus reserve. The creation of a reserve represents a segregation or appropriation of earned surplus. It would therefore be improper to establish a reserve out of capital surplus. Accepted procedures in a reorganization provide for potential losses by charges to capital surplus and related contra credits to asset or liability accounts (as appropriate), rather than to reserve accounts. Should a provision made in this fashion be greater than the actual loss, the excess should be returned to capital surplus.

The wording of the revised Code unfortunately contains the same general phraseology as was used in the old law. The continuation of the phrase "and thereby make available for dividends, without notice to shareholders as to source, any earned surplus remaining," creates confusion as to the intent and meaning of the statute. It would appear to mean that an amount of capital surplus which is greater than the amount of the deficit can be transferred. The result would be not only to eliminate the deficit, but also to leave a credit balance in the earned surplus account. The members of the drafting committee who were interviewed

Underscoring supplied.
stated that they felt it was poor wording in the law and such a practice was not intended. However, it would seem that by this provision it is possible to circumvent the section of the Code which requires notice as to source where dividends are paid from capital surplus. Further, and perhaps more important, such a procedure would destroy the significance of the earned surplus account, even as it is modified under conditions of a "fresh start" as in the case of a quasi-reorganization. It would be most desirable if this portion of the Code were redrafted to state explicitly the procedures and limitations in equity readjustments of this type.

In the elimination of a deficit, the use of capital surplus is limited to that arising from sources other than unrealized appreciation. This provision was carried over from the old law and it represents a sound viewpoint.

The Code provides that in instances where a corporation wishes to undergo a quasi-reorganization but has no capital surplus, stated capital may be reduced, upon the approval of two-thirds of the shareholders, for the purpose of creating a capital surplus. Presumably the board of directors would secure concurrently the shareholder approval for reducing stated capital and the subsequent application of the surplus so created to absorb a deficit.

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26 RC, Sec. 1701.33 (dividends).
27 Munra. v. 24.
26 RC, Sec. 1701.33 (dividends).
27 Munra. v. 24.
The provision requiring a five year balance sheet disclosure of equity readjustments of the type described above seems to be reasonable. The Securities and Exchange Commission requires a disclosure of such action by dating earned surplus for a period of at least three years.28 A broader position has been taken by the American Institute of Certified Public Accountants. It has stated that the dating of surplus would rarely be of significance after a period of ten years and there may be instances in which it could be discontinued within a shorter period of time.29

Evaluation

The grouping of all the provisions relating to surplus into a single new section represents a desirable revision of the law. The definitions of surplus, earned surplus, and capital surplus, while generally consistent with the traditional language of accounting and the law, are not as revealing as to the nature and significance of surplus as they might be. The Code as now written, with capital surplus only designated as any surplus other than earned, needs clarification as to the type of capital surplus under consideration in the various sections. This would involve revision to substitute such terms as paid-in surplus, revaluation surplus, and donated surplus wherever appropriate.

A more desirable approach would be to frame the definitions in terms of measurements of assets which have been acquired from various sources.

The prohibition of including any part of the undistributed profits of another company whose shares are owned is sound, but hardly necessary in light of the definition of earned surplus and the designation of share revaluations as capital surplus. The accounting treatment prescribed for transactions in a company's own shares is a desirable recognition that such transactions represent adjustments of paid-in capital. Further discussion and evaluation of this point are deferred to Chapter V which relates to share acquisitions.

The Code requirements as to classification of capital surplus as to derivation, both on the books and in the balance sheet, are sound and in agreement with accepted accounting practice.

Both of the provisions permitting the recognition of unrealized appreciation should be eliminated as they serve no useful or legitimate purpose. Window-dressing, through the overstatement of both assets and liabilities, is quite possible, resulting in misleading statements. As the law now stands, there are no limitations to this practice, although there are provisions restricting dividends based upon unrealized appreciation. It would seem that until such time as techniques can be developed to periodically restate asset values by some objective means, it would be desirable to prohibit sporadic, and quite possibly subjective, valuations.
If the provisions relating to unrealized appreciation are to be retained, then they should be redrafted to eliminate the confusion as to meaning that presently exists. In the case of revaluation of physical assets, there should be a provision requiring a statement on subsequent balance sheets indicating that the basis of valuation is something other than cost. Further, where the asset which has been written up has a limited life, the capital surplus should be written off to earned surplus concurrently with the write-off of the asset. With regard to shares of other companies valued at their book value, the Code should be clarified by the inclusion of a statement to the effect that reductions of capital surplus are to be made to reflect decreases in book value.

There is a definite need for restatement of the section dealing with the application of capital surplus in the elimination of a deficit in earned surplus. While the recent revision represented desirable changes, there still is a need for clarification as to exactly what may be accomplished under this section. Further revision should provide that a quasi-reorganization may be undertaken upon the approval of the shareholders, and that after restatement of the assets at their fair value and provision for known losses by charges to earned surplus, capital surplus may then be transferred to earned surplus, to the extent of the deficit, in order to wipe out the debit balance. The phrase "make available for dividends without notice" would then
no longer be necessary. The provision permitting the creation of a reserve should be eliminated, and the other provisions relating to the use of unrealized surplus and to disclosure should be retained.
Chapter IV
Dividends

Legal Requirements

The Ohio General Corporation Act sets forth the following requirements with respect to the declaration of payment of dividends.\(^1\)

The directors may declare dividends on outstanding shares of the corporation, subject to the following provisions:

(A) A dividend may be paid out of surplus, in cash, property, or shares of the corporation, except that only a dividend in shares may be paid out of capital surplus arising from unrealized appreciation of assets;

(B) A dividend may be paid in treasury shares or in authorized but unissued shares. If paid in shares with par value, there shall be transferred from any surplus, however created, to stated capital, such amount, if any, as is necessary in order that the stated capital represented by the outstanding shares with par value, after giving effect to such dividend, will be equal to the aggregate par value of such shares, or, if the directors so determine, a greater amount shall be so transferred. If paid in shares without par value, there shall be transferred from any surplus, however created, to stated capital, only such amount, if any, as the directors determine;

(C) No dividend shall be paid to the holders of shares of any class in violation of the rights of the holders of shares of any other class, or when the corporation is insolvent or there is reasonable ground to believe that by such payment it would be rendered insolvent.

(D) No dividend on shares of any class shall be paid in shares of another class if any of the authorized shares of such latter class are

\(^1\)RC, Sec. 1701.33 (dividends).
already outstanding, unless either the articles so provide or such payment is authorized by the affirmative vote of the holders of at least two-thirds of the shares of the class in which payment is to be made;

(E) If the articles of a corporation engaged in whole, or in part in the exploitation of mines, timber, oil wells, gas wells, quarries, or other natural resources so provide, the corporation may compute its surplus for the purpose of paying dividends without making any deduction or allowance for the depletion of said assets incidental to the exploitation and sale thereof;

(F) When any portion of a dividend is paid out of capital surplus, the corporation, at the time of paying the same, shall notify the shareholders receiving the same as to the kind of surplus out of which the dividend is paid.

Development of Dividend Legislation

The growth of legal rules regarding dividends has been strongly influenced by the changes in legal concepts as to capital. As corporate capital, in the legal sense, has become something of a restricted, arbitrary amount, dividend statutes have tended to become more permissive. Kehl, in tracing the evolution of early dividend provisions in both charters and statutes, states that three significant limitations upon the payment of dividends have developed.² The first was a profit limitation, restricting dividends to distributions measured by profits. The charters granted prior to the enactment of state general incorporation laws generally contained provisions of this type.

Later there developed capital impairment limitations in which the directors were liable for declaring dividends out of capital. The New York Act of 1825 contained both a profit limitation and a capital impairment test. The third dividend limitation that developed was the insolvency rule which was contained in the Massachusetts Act of 1830. It made the directors liable for corporate debt if dividends were paid while the company was insolvent or if the company would be made insolvent by such a payment.

The evolution of Ohio dividend provisions seems to have paralleled the general development of dividend restriction in the United States. Davies notes, after setting forth a number of representative provisions, that despite a variety of dividend clauses, by 1852 the capital impairment and the insolvency tests had emerged. The first comprehensive corporation act was passed in 1852, but its dividend section (restricting dividends to profits) was limited to manufacturing companies. Dividend statutes for other types of companies followed and in 1888 the General Code was revised. It provided that corporations could not pay dividends except from surplus profits arising from the business. This remained the legal test for dividends until 1927.

The 1927 act, which provided for the creation of a distributable paid-in surplus, represented a significant change in the

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This summary of the development of Ohio dividend law is taken from Davies, Corporations, pp. 633-638.
philosophy of dividend restriction. Prior to that date the concept of dividends had been that they represented a return derived from the employment of funds invested in the business. Although the Ohio Code has been amended several times since 1927, it still contains a broad concept of dividends which permits distributions of invested capital to the extent that it is not designated as legal capital. In the present law the primary restrictions are a legal capital impairment limitation (dividends only from surplus) and an insolvency rule.

Summary of Code Requirements Relating to Dividends

Section 1701.33 contains the following provisions and restrictions relating to corporate dividends:

(A) Dividends in cash, property, or shares of the corporation, may be paid out of any surplus other than that arising from unrealized appreciation of assets.

(B) Dividends in shares only can be paid out of a capital surplus arising from unrealized appreciation.

(C) Dividends may be paid in treasury shares or in authorized but unissued shares.

(D) As to surplus capitalization upon the issuance of dividends in shares:

(1) If par value shares are issued, there shall be transferred from any surplus to stated capital whatever amount is necessary to maintain the stated capital (after the dividend) at an amount equal to at least the aggregate of the par value of the shares outstanding. If the directors so determine, a greater amount may be transferred.

(2) If no-par shares are issued, there shall be transferred from any surplus to stated
capital whatever amount, if any, the directors determine.

(E) Where shares of one class are already outstanding, additional shares cannot be issued as a share dividend to another class, unless the articles so provide or the action is approved by at least two-thirds of the shareholders of the class in which the payment is to be made.

(F) No dividend shall be paid to the holders of any class of shares:
(1) In violation of the rights of the holders of any other class.
(2) When the corporation is insolvent or there is reason to believe that by payment it would be rendered insolvent.

(G) A corporation engaged in the exploitation of natural resources may compute its surplus, for purpose of paying dividends, without making any deduction for depletion.

(H) When a dividend is paid out of capital surplus, the corporation must notify the shareholders as to the kind of surplus from which the dividend is paid.

Discussion

The Code permits the payment of dividends in cash, other property, or in shares of the corporation. Any surplus other than that arising from unrealized appreciation of assets may be used as the basis for declaration of dividends in cash or other property. Surplus from unrealized appreciation is available only for the issuance of share dividends. Where dividends are based upon a surplus derived from some source other than earnings, the corporation must notify the shareholder as to source. These rules are in substance the same as those contained in the old law prior to the 1955 revision.
The failure to restrict dividends to distributions of assets in an amount no greater than earnings is a reflection of the philosophy contained in the Code as to legal capital. As noted earlier, this represents one of the most significant differences between the viewpoints expressed in the corporate laws and those held by accountants.4 The Ohio statute adopted the present position in 1927, and since that date has used a capital impairment or surplus test in determining the legality of dividends. The practice of distributing assets which are essentially a part of the contributed capital is justified, according to 1930 drafting committee, if the shareholder is notified as to source of the dividend. It is interesting to note the recognition of the character of a dividend in the committee comments:

This is on the theory that the shareholders naturally assume that dividends are paid out of profits or earned surplus and should be notified whenever dividends are paid out of paid-in surplus, surplus arising from the reduction of stated capital or any surplus other than earned surplus.5

The position of accountants as to the meaning of a dividend is consistent with their desire for maintaining a primary distinction between contributed and earned capital. In accordance with this concept a dividend has been defined as "an appropriation of current or accumulated earnings with the intent to distribute an equivalent amount of assets among the stockholders of a particular class on a pro-rata basis."6

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4 Supra, p. 13.
5 Committee Report (1930), p. 15.
Under the present law a corporation may continue to pay dividends if it has a capital surplus other than from unrealized appreciation, even though there is a deficit in earned surplus. Such a provision is detrimental to the position of creditors, particularly where the legal capital is a relatively small amount. In addition to the insolvency rule, there is a need for further restrictions prohibiting the distribution of assets if a deficit in earned surplus is present. The continuation of divided payments in such a situation is misleading to anyone concerned with the enterprise. A court decision, cited by Ballantine in discussing the nature of a dividend, emphasized the inference contained in a dividend declaration: "The declaration of a dividend is the most emphatic assertion that the corporation is in a position to make a division of profits and is consequently enjoying some degree of prosperity."7

If the requirement as to notice upon payment of a dividend based upon surplus other than from earnings is truly effective, then there is no great harm in a surplus rule such as is contained in the Ohio Code. On the other hand, no useful purpose is served by it. Where such a rule exists the possibility of misleading the stockholder, by design or otherwise, is always present. It would therefore seem desirable to limit dividends to an amount no greater than accumulated earnings. Such a limitation would

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result in not only improving the dividend provisions of the Code, but would help to clarify the stated capital section. Since dividend payments based upon capital surplus derived from shareholder contributions would no longer be permitted, then there would be no necessity for retaining the provisions granting the authority to create such a surplus. The effect then would be to state the owners' equity in terms of two primary categories, contributions and earnings. The other possibilities of equity sources would be from asset donation, a relatively rare occurrence, and from asset revaluation, a practice which might well be discarded.

The limitation imposed upon the use of revaluation surplus, restricting it to share dividends only, is a most necessary provision in light of the present law. Otherwise it would be possible to divert genuine asset values and substitute in their place unrealized values, and thus maintain a surplus for dividends without impairment of the amount of capital. This restriction, as noted earlier, was enacted in 1927 at the time the dividend concept was broadened to the surplus test. 8

The phraseology contained in both legal and accounting writing is unfortunate insofar as dividends and surplus are concerned. The expressions "paid out of surplus" and "surplus available for dividends," for example, can create confusion. Surplus, in an accounting sense, is a title of an account used to denote

8Supra, p. 42.
an equity, or asset source, and it does not represent an asset from which a dividend may be paid. The wording used in the old statute was actually superior to that contained in the revision (although that in the latter is consistent with common accounting usage). In essence the old statute said that dividends could be paid out of the aggregate of assets less the aggregate of liabilities plus stated capital. In other words, the amount of surplus assets over and above the amounts obtained from creditors and the amount designated as stated capital. A better phraseology would be to use such expressions as "earned surplus represents the measure of the amount of assets which legally may be distributed as a dividend."

The Code provides that there is no essential difference between treasury shares and authorized but unissued shares insofar as their availability for share dividends is concerned. Consistent with the views of most accountants, it recognizes that treasury shares represent a reduction of ownership equity, but may be reissued at any time, in the same manner that unissued shares may be used. The Code explicitly states that treasury shares, although issued, are not outstanding for dividend purposes. The exclusion of such shares in the calculation of a dividend declaration, either in cash or shares, is considered to be appropriate accounting practice.\(^9\)

\(^9\)RC, 1701.01 (definitions).
\(^10\)Securities and Exchange Commission, Accounting Series Release No. 5 (1938); see also Committee on Concepts and
In connection with the discussion of stated capital and surplus it was noted that the Code grants the board of directors the authority to increase the stated capital of shares outstanding by transfers from any surplus. This may be accomplished either by directive or issuance of share dividends. Further, transfers may be made from earned surplus to capital surplus. Under the revised law, where par shares are issued as a dividend, the only requirement as to surplus capitalization is that there must be transferred an amount sufficient to maintain the stated capital at a figure which is no less than the aggregate par value of the shares outstanding. Since the Code now permits stated capital to be greater than par value, there is no restriction as to the maximum amount that the directors may have transferred. In the case of no par shares, surplus may be capitalized by transfers to stated capital in any amount that the directors determine.

According to the 1955 drafting committee, these changes were made to enable corporations to comply with the New York Stock Exchange regulations. Its explanation of the Exchange rules and the effect of the Code revision upon corporate practices as to share dividends is stated below:

Under the rules of the New York Stock Exchange, where a corporation with listed shares declares stock dividends regularly (other than a dividend which is deemed to be a stock split-up), it is required that earned surplus be charged with an amount approximately equal to the fair market value of the


\[\text{Supra, p. 23 and p. 46.}\]
shares issued by way of the stock dividend, and in that case an equal amount must be credited to stated capital or some other capital account such as capital surplus, or, as stated in some balance sheets, "other capital." Under the revision it will be permissible for an Ohio Corporation upon declaration of a stock dividend to charge earned surplus with an amount equal to the fair market value of the shares to be issued as a stock dividend and then credit either stated capital or capital surplus. If desired, the credit may be made to stated capital, thereby preventing the amount so credited from being used thereafter in payment of dividends.\(^{12}\)

The New York Stock Exchange pronouncement relates to all stock issues which represent no more than 25% of the shares outstanding prior to the distribution. In situations where the new shares represent more than 25% of the shares outstanding, the transaction may be deemed to be a stock split, with no concurrent surplus capitalization required. The American Institute of Certified Public Accountants is in agreement with this treatment of share dividends and splits. They have taken the position that the practice of capitalizing earned surplus at market values for issues up to 20-25% of the outstanding shares is justified due to the fact that the transaction would normally have no effect on the market price and that many recipients look upon such dividends as income. They state further that where the additional shares issued as a dividend are so great (over 20-25%) as to materially reduce the market price of the shares, the transaction

\(^{12}\)Committee Report (1955), pp. 54-55. See also New York Stock Exchange Release, Treatment for Stock Dividends by Issuer (1953).
is essentially a stock split and should be accounted for as such. In this situation there would be no need to capitalize earned surplus other than is necessary to comply with legal requirements. The Securities and Exchange Commission has as yet not issued a statement on this subject in the form of an Accounting Series Release. However, they have ruled, in the case of a registrant filing a report, that a stock dividend must be accounted for by capitalization of earned surplus at the market value of the shares, rather than at their par value. Thus their position in this matter appears to be consonant with that of the New York Stock Exchange and the American Institute of Certified Public Accountants.

In their statement as to treatment of share dividends, the American Institute of Certified Public Accountants has recognized the existence of state laws requiring a transfer of surplus upon the issuance of share dividends. Accordingly, they have attempted to state what they believe to be a desirable general rule, while at the same time permit compliance with legal requirements. Thus in the case of capitalizing surplus at the market value of shares, they have used the phrase "transferring from earned surplus to permanent capitalization (represented by the capital stock and capital surplus accounts)." This obviously overlooks the legal nature of capital surplus, for under the laws in Ohio (and other

states as well) such a capital surplus would be legally available as a basis for either share or cash dividends at a later time. Often accountants view this type of capital surplus as "permanent capital" and treat it as though it were legal capital.

In the counterpart to the above statement the American Institute of Certified Public Accountants has set forth another general rule to the effect that in any large distributions which would affect the market price of the shares, no surplus capitalization is required. An exception is permitted, however, where legal requirements are to the contrary.

Since stated capital may now be an amount greater than par value, and since transfers may be made from earned surplus to capital surplus, Ohio corporations will have no difficulty in complying with the rule as to capitalization at market value of the shares. However, they cannot always comply with the second rule that no transfers are to be made if the distribution is so large as to be, in effect, a stock split. Where par shares are issued as a stock dividend, a surplus transfer must be made. This is necessary due to the requirement that stated capital be at least equal to the aggregate par value of the shares outstanding.

The use of market values in determining the amount of surplus to be capitalized is difficult of justification if any serious consideration is given to the significance of the accounts used to reflect the ownership equity. Paton and Paton, in criticizing this practice, point out that market values of
shares represent the current appraisal of the entire equity per share (including both capital stock and earned surplus), and accordingly, there is no reason to the proposal to use the market value of the entire equity as a unit of measure in a transfer from one section to another. They suggest that the average amount received per share from stockholders is the most appropriate basis for determining the amount to be capitalized for share dividends. This would appear to be a sounder and more logical approach than the use of market values.

The position of the American Institute of Certified Public Accountants that market values should be used as the basis for earned surplus capitalization is untenable. After recognizing that share dividends are not income, they then justify the use of those values on the grounds that they believe the recipients look upon share dividends as income in an amount equivalent to the current value of the shares. It is doubtful that shareholders look at anything as income if it is not taxable as such. If this misconception does exist however, it would seem that the use of market values would, if anything, further the misunderstanding.

From the accountant's standpoint, any transfer from earned surplus presents a problem, as the surplus figure then ceases to be a measure of the total accumulated earnings retained in the enterprise. If the amounts transferred are credited directly

to the capital stock accounts, then the result is a distortion of both equity divisions, and they no longer reflect the distinction between amounts of capital contributed to the enterprise and amounts earned by it and retained. The solution seems to be in accounting for earned surplus in two divisions: that which is the measure for dividend distributions and that which is not as a result of transfer to legal capital. This is discussed further in Chapter VII which is concerned with reporting and disclosure.

Another new provision in the Ohio Code relates to protection of equity against dilution in certain instances of share dividends. It prohibits the issuance of shares of one class as a share dividend to another class, unless such a procedure is provided for in the articles or is approved by two-thirds vote of the shares of the class which is being diluted.

The Code provision permitting companies engaged in the exploitation of natural resources to compute their dividend base without regard to depletion is in substance unchanged from the prior law. Its purpose is to provide a means for gradual liquidation of corporations which do not intend to reinvest their assets in similar resources at the conclusion of their present operations. In such a situation it would appear that the use of this provision might operate to the detriment of preferred shareholders whose shares have a liquidation preference. According to Davies, the use of this rule in this situation would be governed by the provision that no dividend may be paid in
violation of the rights of the holders of any other class of shares.15

Evaluation

The Code provisions relating to dividends, reflecting a broad viewpoint as to the legal measure of distributable assets, are not as desirable as the former, more restrictive rules contained in the act prior to 1927. No sound purpose is served by the present permission to allocate a portion of shareholder contributions to a capital surplus which may then be used as a basis for dividend distributions. The concept of a dividend generally is that it represents a distribution of earnings which have been derived from the use of invested capital. Any provisions permitting other distributions tends to be misleading and should not be continued in the law. It would therefore be desirable if the legality of dividends were measured only by accumulated earnings.

Where share dividends are concerned, the provisions of the revised Code are acceptable in light of the prevailing views of the American Institute of Certified Public Accountants, the Securities and Exchange Commission and the New York Stock Exchange. Until such time as these groups revise their position in this matter, there is little that the Ohio law can do but to facilitate compliance. A more desirable practice would be to effect transfers from earned surplus to legal capital, upon

15Davies, Corporations, pp. 664-665.
the issuance of share dividends, in amounts per share equivalent to the average amount paid-in by shareholders. There is no sound reason why the stated capital per share should be increased or decreased because of the issuance of share dividends. In the case of a stock split to bring about a reduction in the market price of shares, no change in the equity accounts is intended. Therefore there is no reason why the aggregate stated capital should ever be increased in such a situation.

In the matter of phraseology it would be desirable if the Code wording were revised. The substitution of such expressions as "surplus is the measure of the amount of distributable assets" in place of "dividends may be paid from surplus," would do much to promote a better understanding of surplus and dividends. In a similar fashion, "issuance of share dividends" might be used to replace "dividends may be paid in shares," thus avoiding any unwarranted connotations arising from the use of the word "paid."

The provisions relating to protection against dilution in share dividends and payments creating insolvency or in violation of the rights of other classes of shareholders are desirable since they help to maintain the rights and interests of the various equities.
Chapter V

Acquisition of Own Shares

Legal Requirements

The Ohio General Corporation Act provides the authority for a corporation to purchase its own shares under specified conditions and sets forth certain limitations to such purchases.¹ Those provisions which are pertinent to this discussion are set forth below:

(A) A corporation by its directors may purchase shares of any class issued by it, in any of the following instances:

(1) When the articles authorize the redemption of such shares and do not prohibit such purchase.

(9) When authorized by the articles, or by the shareholders at a meeting called for such purpose, by the affirmative vote of the holders of two-thirds of the shares of each class, regardless of limitations or restrictions in the articles on the voting rights of the shares of any such class, or, if the articles so provide or permit, a greater or lesser proportion, but not less than a majority of the shares of any class.

(B) A corporation shall not purchase its own shares except as provided in this section, or if after such purchase its assets would be less than its liabilities plus stated capital, or if the corporation is insolvent; or if there is reasonable ground to believe that by such purchase it would be rendered insolvent.

(C) Shares issued by a corporation which owns or controls shares entitling it to elect a majority of the directors of another corporation may be purchased by such last mentioned corporation only when and if such shares could

¹RC, Sec. 1701.35 (purchase of own shares by corporation).
be purchased by the issuing corporation pursuant to paragraph (9) of division (A) of this section.

Other legal requirements relating to share acquisitions have been noted in Chapter II (Stated Capital) and Chapter III (Surplus). The discussion in this chapter will consider those requirements as well as the provisions in Section 1701.35.

Discussion

The Ohio Code grants practically an unlimited authority for a corporation to repurchase its own shares. In addition to certain specified conditions, such as the acquisition of redeemable shares, it permits the corporate articles to contain a general authority, and in the absence of such a provision, when the action to repurchase is approved by two-thirds of the holders of the shares of each class.

Specific requirements which have accounting implications are contained in the sections dealing with reductions of stated capital and surplus. Section 1701.31 states that whenever shares are redeemed or when purchased or otherwise acquired, the stated capital of the class to which the shares belong is to be reduced by an amount equal to the stated capital of the shares acquired. This rule excludes any shares acquired by the corporation upon conversion, change or exchange, as in these instances new shares are issued in place of the old ones.\(^2\) The provisions dealing

\(^2\)\textit{Supra}, p. 24.
with the effect of share transactions on the surplus of a corporation are set forth in Sec. 1701.32. This section provides that (1) profits and gains from transactions in the shares of the corporation do not constitute earned surplus, (2) losses from transactions of this type may be charged against the capital surplus resulting from previous profits and gains, and (3) any balance of losses shall be charged against earned surplus.3

The provision requiring that the corporate stated capital be reduced upon the acquisition of shares represents a recognition that a contraction of capital has occurred and that treasury shares (where a question as to treatment might arise) are not to be considered as an asset of the corporation.4 The 1955 Code revision provides for an automatic reduction of stated capital upon acquisition of treasury shares, a change from the former law under which a reduction was effected only by action of the board of directors to retire such shares. Further, in the revised law a specific statement has been added to the definition of treasury shares to the effect that they are not to be considered as an asset, nor are they outstanding for dividend or other purposes.5

The requirements as to the treatment of gains and losses arising from transactions by a company in its own shares are new and they bring the Ohio statute closer to generally accepted

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3 Sunra, p. 39.
5 RC, 1701.01 (definitions).
accounting concepts. In general the revised Code provisions relating to share acquisitions represent a substantial improvement over the requirements of the former law. There is, however, one major variation in the current Code provisions from recommended accounting procedures. This exception lies in the area of appropriate treatment of losses in share transactions (arising from payment, upon reacquisition, of an amount greater than the shareholders' original contribution). The present law permits grouping of all gains as a capital surplus item which may be used to offset any later losses, with any remaining balance of losses chargeable against earned surplus. The position that accountants take is that each transaction in a company's own stock is a separate and independent capital adjustment. This concept has been stated by the American Accounting Association as follows:

> An outlay by a corporation for shares of its own stock should be treated as a reduction of paid-in capital up to the prorata amount represented by the acquired shares, whether or not such shares are reissuable. If the outlay for the reacquired shares exceeds the prorata reduction of paid-in capital, the excess should be treated as a distribution of retained income. The reissue of acquired shares should be accounted for in the same manner as an original issue of corporate shares.

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The difference between the application of the Code rules and the accounting procedures outlined above may be observed in the following illustration relating to treasury shares. Assume that a corporation has a stated capital of $105,000 (represented by 1,050 shares of capital stock having a stated value of $100 each) and an earned surplus of $11,700. The acquisition of 50 shares of stock at $94 per share would be accounted for by the following entry:

| Treasury Stock | $5,000 |
| Capital Surplus (from treasury shares) | $300 |
| Cash | $4,700 |

After giving effect to this transaction the owners' equity in the corporation would appear as follows:

| Capital Stock Issued | 1,050 shares | $105,000 |
| Less - Treasury Stock | 50 shares | $5,000 |
| Capital Stock Outstanding | 1,000 shares | $100,000 |
| Capital Surplus (from treasury shares) | | $300 |
| Earned Surplus | | $11,700 |
| Total Stockholders' Equity | | $112,000 |

If 50 additional shares were then acquired at $115 per share, under the Ohio law the $750 excess over stated value would be charged first against the capital surplus, and the remaining balance against earned surplus. The entry would be:

| Treasury Stock | $5,000 |
| Capital Surplus (from treasury shares) | $300 |
| Earned Surplus | $450 |
| Cash | $5,750 |

Quite a different result is obtained if a pro-rata reduction is applied to the paid-in capital accounts as is prescribed by the American Accounting Association. Under this rule the entry to record the acquisition would be as follows:
Treasury Stock 35,000
Capital Surplus (from treasury shares) 15
Earned Surplus 735
Cash 35,750

The charge of $735 to earned surplus may be identified as two things: first, a $585 amount representing 5% of the earned surplus balance (the portion attributable to the shares retired), and second, a $150 distribution to these stockholders over and above the book equity that their shares represent (50 x 3%).

The application of the present Code provisions results in a misstatement of the equities and is therefore undesirable from the standpoint of accurate accountability. The permission to charge losses fully against any previous gains may result in using capital surplus to absorb a charge which properly should be made to earned surplus (as in the preceding illustration). The result is to leave a greater earned surplus balance available as the basis for dividends. This distinction, however, is not particularly important where any surplus, earned or otherwise, may be used as the measure of dividend distributions.

As a matter of convenience, and perhaps in compliance with state corporate laws, accountants have at times accounted for treasury shares at cost of acquisition. This practice is sometimes justified on the basis that the transaction is incomplete and the treasury shares should be viewed as a capital element awaiting final disposition. The result is the holding of treasury shares as an unallocated reduction of the owners' equity. In general this method is not desirable, as it may permit, upon
reissue of the shares, a diversion of equity balances as was illustrated in the above example. This may be observed in a situation in which shares are reacquired under conditions requiring a charge to earned surplus. If they are later issued at a greater price, the excess proceeds are in effect used to absorb the charge which properly should have been made to earned surplus. The approach in which each share transaction is viewed as a separate capital adjustment would seem to be the sounder method. Under the Ohio Code, since its revision, the use of the cost basis is not permitted, as the law now requires that stated capital be reduced upon the acquisition of treasury shares.

Where an allocation has been made to capital surplus upon the original issue of shares, a problem exists as to the disposition of such a surplus at time of reacquisition. The Code fails to provide any definitive answer. However, one of the Committee members who was interviewed stated that he believed the law intended the application of whatever accounting procedures might be appropriate. In other words, the matter is left to the accountant. Presumably then, where preferred stock, for example, had a stated value and a par value of $100 per share but had been originally issued at $102, the entry to record its redemption at $105 per share would be as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Stock</td>
<td>100</td>
</tr>
<tr>
<td>Capital Surplus (paid-in)</td>
<td>2</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td>3</td>
</tr>
<tr>
<td>Cash</td>
<td>105</td>
</tr>
</tbody>
</table>

In the above entry the excess of the amount paid over the stated
value and capital surplus (per share) represents the net redemption premium charged to earned surplus. This is consistent with entries in the earlier illustration except that here the preferred stock has no pro-rata claim to the earned surplus. Any unpaid dividends at the date of the redemption would of course be due to the preferred shareholders and properly chargeable to earned surplus.

The Code provides, by way of a limitation upon share acquisitions, that a corporation may not purchase its own shares if (1) after the shares are acquired the assets are less than the liabilities plus stated capital, or (2) the corporation is insolvent or there is reason to believe that the purchase would cause it to be insolvent. The effect of the first limitation is that, in the absence of a surplus, shares could be reacquired at a price no greater than their stated capital. Obviously, where a surplus exists, a greater amount can be paid, as the excess is chargeable to surplus and the above rule is not violated. If a firm has a large surplus, then this limitation could have no practical effect. This rule represents a substantial change from the former law which provided that the outlay for treasury shares could be no greater than the amount of surplus.

The primary need for limitations upon the purchase of treasury shares arises from the fact that such transactions represent an unanticipated return of assets to owners. This is particularly true in the case of common shares. Creditors or other investors may have relied upon the existence of this amount of
funds in granting credit or making other asset commitments to the enterprise. The expectation is that an amount of assets at least equivalent to the legal capital will be retained in the corporation. The failure to restrict outlays for treasury stock, in situations where it effects a reduction of stated capital, is hardly consistent with the philosophy of corporate organization.

The 1952 drafting committee justified this change in the law primarily on the basis that the old requirement, in effect, provided no limitation.\(^7\) The committee attributed this conclusion to the fact that in the absence of a surplus, a corporation could create one by writing down stated capital, and further, that treasury shares could be retired, thus removing the limitations on surplus for dividend purposes. It would seem desirable to retain a surplus rule as a limitation upon the purchase of common treasury shares, with two added provisions to the effect that (1) surplus created by the reduction of stated capital could not be used as a basis for treasury stock acquisitions, and (2) where treasury shares are retired an amount equivalent to their cost must be transferred from surplus to stated capital. These requirements would preserve the integrity of the stated capital figure by insuring that it represented an amount of permanent capital retained in the enterprise.

\(^7\)Committee Report (1952), p. 5.
Evaluation

The present Code requirements as to the accounting treatment of share transactions are in general sound and desirable in light of the current concept of legal capital. The adoption of a provision requiring corporations to make pro-rata reductions of the paid-in equity upon reacquiring their own shares would result in an improvement in the law. Such a change would not only provide a sounder procedure for treating losses and gains on treasury shares, but would also set forth a general rule as to the treatment of all paid-in equity accounts. Such a statement is not contained in the present law.

The most desirable procedures for accounting for share acquisitions would stem from the requirements recommended as for stated capital. If allocations to capital surplus were prohibited and the entire amount of owner contribution became stated capital, then the treatment accorded the reacquisition of shares would be greatly simplified. At the same time it would be consistent with the concept of stated capital. To illustrate, assume the same facts as in the example on page 76: corporate stated capital of $105,000 (represented by 1,050 shares of capital stock having a stated value of $100 each) and earned surplus of $11,700. The acquisition of the first 50 shares would be recorded as follows:

| Treasury Stock | $4,700 |
| Cash | 34,700 |

Since the price paid is less than the stated capital of the
shares acquired, the corporate stated capital is reduced by the amount of the purchase price. At this point the stated capital per share would be $100.30 and the total equity per share $112.00. The shareholders' equity in the corporation would now be shown:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock Issued</td>
<td>1,050 shares</td>
</tr>
<tr>
<td>Less - Treasury Stock</td>
<td>50 shares</td>
</tr>
<tr>
<td>Capital Stock Outstanding</td>
<td>1,000 shares $100,300</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td>$11,700</td>
</tr>
<tr>
<td>Total Stockholders' Equity</td>
<td>$112,000</td>
</tr>
</tbody>
</table>

In this transaction the owners whose shares were purchased did not receive assets equivalent to their full equity as recorded in the accounts. As a result, this difference accrues for benefit of the remaining shareholders. The effect of recording the acquisition by the above entry is to maintain the same distinction between contributed and earned capital that existed prior to the transaction. The $300 portion of contributed capital which was not returned remains as legal capital (increasing stated capital per share), and the outgoing owners' portion of earned surplus ($557) remains as a measure of legal dividend distributions. The adjustment of stated capital per share is consistent with the present Code provisions requiring similar adjustments when shares are issued at different prices.

Following the original illustration, the entry to record the acquisition of the second 50 shares would be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Stock</td>
<td>$5,015</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td>735</td>
</tr>
<tr>
<td>Cash</td>
<td>$5,750</td>
</tr>
</tbody>
</table>

The charge to earned surplus is necessary because the acquisition price is greater than the stated value of the shares. As
in the earlier example, this charge may be identified as $585 representing the portion of earned surplus attributable to the shares which were retired, and $150, a special distribution representing the excess of the amount paid over the recorded book value.

Insofar as limitations to share acquisitions are concerned, the present Code restrictions do not appear to be as stringent as they might be. The position of creditors (and perhaps stockholders as well) might deteriorate considerably before the insolvency rule would operate. While such a rule is necessary and desirable to prevent, in effect, a final liquidation with creditor claims unsatisfied, it is by no means an adequate safeguard. Creditors should be afforded the stated capital margin as a buffer against operating losses so long as their claims are outstanding. If the margin is reduced by asset distributions to owners, then the position of creditors is weakened even though the distribution does not create insolvency. The other primary limitation, that of prohibiting stock acquisitions if after the purchase the assets would amount to less than the liabilities plus stated capital, is also not a truly adequate restriction. The only requirement that this rule imposes is that there must be a surplus to absorb the excess, if any, of the price paid over the stated capital attributable to the shares. It would seem that limiting the outlays for treasury stock to an amount no greater than surplus (preferably earned surplus), with a concurrent limitation on dividend distributions, would be
the most desirable type of restriction. To avoid circumvention of the intent of such a rule, it would be necessary to incorporate additional provisions in the Code. These would require the exclusion of surplus created by the reduction of stated capital from being used as the measure of stock acquisitions and transfers from surplus to stated capital upon the retirement of treasury shares.

If it is desirable to permit a general contraction of corporate capital, then the Code should provide for it in the Reduction of Stated Capital Section. A reduction of this nature would best be accomplished by pro-rata distributions to owners, rather than by the acquisition of treasury stock on an informal basis.
Chapter VI
Merger and Consolidation

Legal Requirements

The following merger and consolidation provisions of the Ohio General Corporation Act are of significance from an accounting standpoint:

Merger and Consolidation Procedure

(A) Any two or more corporations may merge into a single corporation which shall be one of the constituent corporations, or may consolidate into a single corporation which shall be a new corporation to be formed by the consolidation.

(B) To effect such merger or consolidation, the directors of each constituent corporation shall approve an agreement of merger or consolidation to be signed by the president or a vice-president and by the secretary or an assistant secretary of such corporation, which agreement shall set forth:

(6) The amount, or the method of determining the amount, of stated capital of each class of shares to be outstanding at the time the merger or consolidation becomes effective, but the aggregate of the amounts of stated capital of all classes shall be not less than five hundred dollars, and the stated capital of each share with par value to be outstanding shall not be less than the par value of such share;

(9) The terms of the merger or consolidation, the mode of carrying the same into effect, and the manner and basis of making distribution to shareholders of the constituent corporations, which distribution to shareholders of any of the constituent corporations, in extinguishment of or in substitution for shares of such constituent corporations, may be by way of shares

1RC, Sec. 1701.78 (merger and consolidation procedure) and Sec. 1701.61 (effect of merger).
of any class or classes of the surviving or new corporation, or of property other than such shares (including, but not limited to cash, notes, bonds, other evidences of indebtedness, or other property), or partly of such shares and partly of such other property, or which may consist of any combination thereof; provided that, after giving effect to such distribution, there shall be reserved an amount of assets which, taken at their fair value to the surviving or new corporation, is not less than the sum of the liabilities of the surviving or new corporation, including those derived by it from the constituent corporations, and the amounts of stated capital and surplus specified in the agreement; and provided that no such distribution shall be effected if, when the merger or consolidation becomes effective, the surviving or new corporation is insolvent or there is reasonable ground to believe that, by such distribution, it would be rendered insolvent;

(C) The agreement may also set forth:

(1) A declaration of the fair value to the surviving or new corporation of the assets to be possessed by it;

(2) A statement that the earned surplus of the constituent corporations or any part thereof shall constitute earned surplus of the surviving or new corporation;

(3) A statement that all or any portion of the amount representing an excess of the assets of such surviving or new corporation, taken at their fair value to the surviving or new corporation, over the aggregate of its liabilities, including those derived by it from the constituent corporations, plus stated capital, shall constitute capital surplus of the surviving or new corporation;

Effect of Merger

(A) When such merger or consolidation becomes effective:

(7) All the rights of creditors of each constituent corporation shall be preserved unimpaired.
(9) The aggregate surplus of the constituent corporations available for the payment of dividends immediately prior to the merger or consolidation shall, to the extent remaining as surplus of the surviving or new corporation, continue to be available for the payment of dividends by the surviving or new corporation.

**Summary of Code Requirements**

The merger and consolidation provisions which set forth accounting requirements are outlined below:

(A) Authority is granted for two or more companies to merge or to consolidate. A merger is the combination of two or more corporations, with one of the original retaining its identity. A consolidation is the combination of two or more corporations into a single new corporation.

(B) To effect a merger or consolidation the directors of each constituent corporation must approve an agreement which shall set forth:

(1) The amount of stated capital for each class of shares. The aggregate amount cannot be less than five hundred dollars and the stated capital of par shares must be at least equal to the par value of the shares outstanding.

(2) The basis of distribution of property and/or shares. After the distribution there must remain an amount of assets, taken at their fair value to the new or surviving corporation, equal to the sum of the liabilities plus the stated capital and surplus specified in the agreement. No distribution is to be made if the corporation is insolvent or there is reason to believe that it would be insolvent after the distribution.

(C) The agreement may also set forth:

(1) A declaration of the fair value of the assets to the surviving or new corporation.

(2) A statement that the earned surplus of the constituent corporations, or any part of it, is to constitute the earned surplus of the surviving or new corporation.
A statement that all or any part of the excess of the fair value of the assets over the sum of the liabilities plus stated capital shall constitute capital surplus of the surviving or new corporation.

(D) At the time a merger or consolidation becomes effective:

(1) The rights of all creditors of each of the constituent corporations shall be preserved unimpaired.

(2) The aggregate surplus of the constituent corporations available for dividends, to the extent remaining, shall be available for dividends to the surviving or new corporation.

Discussion

The provisions of the Ohio Code permitting mergers and consolidations were first adopted in 1927, and subsequently revised in 1929 and 1939. As presently stated the law provides authority for corporations either to merge or consolidate, and it clearly distinguishes between the two types of combination. A merger is designated as being the combination of two or more corporations, with one of the original retaining its identity. A consolidation is a combination of two or more corporations, with a single new corporation being formed in place of the old ones. The specific Code requirements, however, make no distinction between the two insofar as the means of accomplishment is concerned. The provisions which are set forth are applicable regardless of the type of combination undertaken.

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2 Davies, Corporations, pp. 951-952.
Accountants also have come to disregard the form of combination in attempting to determine appropriate accounting practices. They have been more concerned with the substance of the combination than the particular legal form which it might take. As a consequence, accountants have come to distinguish between transactions which are regarded as a purchase of assets and those which represent a pooling of interests. The essential differences between these types of transactions, as set forth by the American Institute of Certified Public Accountants, are outlined below: 3

(A) A purchase is a combination in which an important part of the ownership interests in the acquired corporations is eliminated, or in which certain other factors requisite to a pooling of interests are not present.

(B) A pooling of interests is a combination in which the holders of substantially all of the ownership interests in the constituent corporations become owners in the surviving corporation. The continuation in existence of one or more constituents as a subsidiary does not prevent the combination from being a pooling of interests if no significant minority interests remain, and if there are significant tax, legal, or economic reasons for retaining the subsidiary relationship.

(C) Additional circumstances to be examined in determining whether a combination should be

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described as a purchase or a pooling of interests would include: (a) the proportionate interests of the shareholders in the new corporation in relation to their holdings in the predecessors, (b) voting rights, (c) continuity of business activities and management. Where any of these factors have been substantially changed, the transaction is deemed to be a purchase rather than a pooling of interests. Relative size of the constituent companies is not necessarily governing unless one company is clearly dominant, in which event treating the combination as a pooling of interests would be inappropriate.

The appropriate accounting procedures for these two types of combinations are quite different. In a transaction considered to be a purchase (regardless of the method of effecting payment), the assets are recorded on the books of the acquiring corporation at cost, measured by the cash outlay, or, in the event other consideration is given, by the fair value of the other consideration or the fair value of the property acquired. A pooling of interests is based upon another concept entirely. Since continuity of the constituents is the underlying assumption, it is considered that no new basis of accountability arises. Therefore, the various accounts, including surplus and deficits, may be properly combined and carried forward on the books of the new or surviving enterprise. There are no rules as to the determination of the amount of stated capital which the combined corporation should have, but general rules as to the treatment of an excess or deficiency (in relation to the aggregate stated capital of the constituents) are set forth. Where stated capital is greater, the excess may be deducted first from capital surplus,
and next from earned surplus. In instances of a lesser new
stated capital, the difference should be treated as capital sur-
plus, analogous to that created by a reduction in stated capital
where no combination is involved.

A comparison of the preceding accounting practices with
those permitted under the Ohio Code reveals several significant
differences. Aside from the fact that the legal provisions tend
to be minimal and therefore are not as definitive as the procedures
outlined by accountants, the inconsistencies stem from the dis-
tinction that the accountants have drawn between a purchase and
a pooling of interests. As far as the Code is concerned, its
provisions are available in any instance, and as a result they
are much more permissive.

Under the Ohio law any merger or consolidation may be ef-
fected in such a manner as to carry over any or all of the earned
surplus of the constituent companies to the surviving or new
company. The Code further provides that the aggregate surplus
available for dividends in the individual companies is equally
available, to the extent remaining, to the combined corporation.
The accountants' position in this matter is that such provisions
should be used only if the combination can properly be considered
as a pooling of interests.

Another permission granted in the Code is that of using
fair values and thereby creating a capital surplus in the sur-
viving or new corporation. The use of fair values in a merger
or consolidation, according to accepted accounting procedure,
would be limited only to those acquisitions which would be deemed to be a purchase. Their use in a combination which constituted a pooling of interest would therefore be inappropriate. 4

The Code limitations as to the amount of stated capital are consistent with the minimal requirements set forth in Sections 1701.30 and 1701.31; 5 namely, the aggregate amount can be no less than five hundred dollars and the stated capital of par shares must be at least equal to the par value of the shares outstanding. It would seem desirable, in the absence of unusual circumstances, if the stated capital of the surviving or new corporation were required to be at least equal to the aggregate stated capital of the constituent companies prior to the combination. The law specifically states that the rights of creditors are to be preserved through the process of consolidation or merger. However, it is possible under the present provisions for the stated capital margin afforded to creditors to be diminished unduly, resulting in an impairment of their position. This is particularly significant in light of the fact that the agreement of merger or consolidation, through its plan of distribution of property (and/or shares), may provide a means of returning to owners an amount of assets which would otherwise be legal capital.


5 Supra, pp. 6-7.
The only real limitation upon such distributions is an insolvency rule applicable to the surviving or new corporation. Unfortunately, at the point which that rule would operate the position of creditors would have already deteriorated excessively.

The Ohio Code gives no recognition to the preparation and use of consolidated financial statements. This absence of consideration is not surprising, however, as the statute is concerned only with regulation of individual legal entities. Consolidated reports, on the other hand, are devised to display the financial picture of a group of separate enterprises which as a whole comprise a distinct economic entity. In general, the entity concept embodied in consolidated statements has no recognized place in the law, although there have been court decisions in which these reports have been sanctioned and relied upon.  

The American Accounting Association has set forth two basic principles of consolidated financial statements, stating generally the area of consolidation and the objectives to be achieved. Their pronouncement is as follows:

(A) In the absence of special circumstances, consolidated statements are useful representations of financial position and results of operations when a dominant central financial interest in two or more companies exists and is accompanied by administrative control of their activities and resources.

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Insofar as practicable, the consolidated data should reflect the underlying assumption that they represent the operations, resources, and equities of a single entity.\(^7\)

In the matter of appropriate procedures in preparing consolidated reports, some difference of opinion exists among accountants. The American Accounting Association, reflecting a traditional viewpoint, has stated that consolidated earned surplus should exclude any earned surplus of subsidiary companies which was accumulated prior to the date of acquisition.\(^8\) The American Institute of Certified Public Accountants, on the other hand, has taken the position that where the acquisition meets the requirements of a pooling of interests, it is not inappropriate to combine the surplus accounts in their entirety.\(^9\) This practice, representing a relatively new concept in accounting, appears to have not yet received widespread adoption, according to the results of a recent survey of the American Institute of Certified Public Accountants.\(^10\)

\(^8\)Ibid., p. 32.
\(^9\)Committee on Accounting Procedure, *op. cit.*, p. 22.
\(^10\)Research Department, *Survey of Consolidated Financial Statement Practices* (New York: American Institute of Certified Public Accountants, 1956), p. 22. In this survey, conducted in 1954, 9 out of 329 corporations indicated that their statements were prepared reflecting the concept of a pooling of interests. No indication was given as to the number of companies whose acquisitions were such that they could have used this approach in consolidation. Since 1954 the *Accounting Research Bulletin* on business combinations has been revised to state explicitly that it is proper to use the pooling concept in consolidated financial statements. It might be assumed that since this release the practice may be more widespread.
As has been noted earlier,\textsuperscript{11} the present Ohio statutes apparently do not in any way prohibit the preparation of consolidated financial statements. Presumably the principles of either a purchase or a pooling of interests could be used without conflict. It would be desirable, however, if the Code contained a definite statement recognizing consolidated reports. This could be achieved, in the section relating to annual financial statements, by a provision to the effect that in addition to parent company statements, consolidated reports might be prepared which reflect the financial position and results of operating activities for the economic entity as a whole.

\textbf{Evaluation}

The present Ohio Code sections which relate to merger and consolidation are not entirely in agreement with the procedures considered as appropriate by many accountants. As currently written they do not prohibit the use of recommended accounting procedures. However, these provisions are not as desirable as they might be since they are extremely broad and overly permissive.

The American Institute of Certified Public Accountants has drawn a distinction between a "purchase" and a "pooling of interests" in an attempt to distinguish between different conditions of acquisition. Actually, they are recognizing that there may be instances of purchase in which it is desirable to make an

\textsuperscript{11}\textit{Supra}, p. 39.
exception to the general rules of asset valuation. Normally, in any acquisition the assets are recorded at their fair market value, measured by the cash outlay or the fair market value of non-cash consideration. However, where a purchase of the net assets of a going concern is made substantially by the issuance of shares, it may be appropriate to reflect the same asset and equity values that were carried by the acquired company.

It would seem that the method of acquisition and continuity of operations should be the basic criteria in judging whether or not an exception is to be made to the usual principles of asset valuation. Where one company buys the assets and assumes the liabilities of another company by the payment of cash or the issuance of debt securities (or a combination of both), the net assets of the surviving company are no greater than before the combination. The same result is accomplished by the purchase of outstanding shares without dissolution of the acquired company. In both of these instances it would be improper to carry over any surplus of the constituents at date of acquisition, as the substitution of one type of assets for another should in no way affect the legal capital or dividend base.

Where shares are issued to effect the combination of two or more currently operating companies a pooling of interests has occurred, and the surviving or new company is a reflection of the combined assets and earning power of the constituents. Under such circumstances it is appropriate to depart from the cost
basis, and the assets, the liabilities, and the surplus accounts could be properly combined at their recorded book amounts.

If a distribution of assets or debt securities occurs as a part of a share exchange in the acquisition of another enterprise, the amount of such distributions should be used to reduce the surplus acquired by the surviving or new corporation. Distributions of this type are essentially an immediate or deferred dividend, and represent an amount of assets not acquired by the combined enterprise that continues in existence. Should these distributions be so great as to absorb the surplus of the constituents, then it would appear to be inappropriate to value the assets on any basis other than their fair value, as there would be no true pooling of interests.

The use of fair values should be considered improper where a combination has occurred under conditions of a pooling of interests. The assignment of fair market values to all of the assets can be justified only on the basis of a "fresh start," where in effect a new corporation comes into existence. The situation is quite similar to the position of a company just after completing a reorganization. In instances where fair values are used, it would seem inappropriate to carry over any surplus, and the entire amount of net asset values should be reflected as legal capital.

It would be desirable if the present merger and consolidation provisions of the Ohio Code were revised to distinguish between the types of asset acquisitions and explicitly recognize
the concept of a pooling of interests. The practice of carrying over surplus at date of acquisition should be prohibited in any instances other than a pooling of interests. In the latter situation the new stated capital should be equal to the aggregate stated capital of the constituents in order that creditors be afforded the same degree of protection that they enjoyed prior to the combination. The permission to use fair market values should carry with it a concurrent limitation upon carrying over any surplus to the surviving or new corporation.
Chapter VII
Reporting and Disclosure

Legal Requirements

The Ohio General Corporation Act contains the following provisions relating to reporting and disclosure in annual financial statements:

(A) At the annual meeting of shareholders, or the meeting held in lieu thereof, every corporation, except a banking corporation, shall lay before the shareholders a financial statement consisting of:

1. A balance sheet containing a summary of the assets, liabilities, stated capital, and surplus (showing separately any capital surplus arising from unrealized appreciation of assets, other capital surplus, and earned surplus) of the corporation as of a date not more than four months before such meeting; if such meeting is an adjourned meeting, said balance sheet may be as of a date not more than four months before the date of the meeting as originally convened;

2. A statement of profit and loss and surplus, including a summary of profits, dividends paid, and other changes in the surplus accounts of the corporation for the period commencing with the date marking the end of the period for which the last preceding statement of profit and loss required under this section was made and ending with the date of said balance sheet, or in the case of the first statement of profit and loss, from the incorporation of the corporation to the date of said balance sheet.

(B) The financial statement shall have appended thereto a certificate signed by the president or a vice-president or the treasurer or an assistant treasurer of the corporation or by

1RC, Sec. 1701.38 (annual financial statements).
a public accountant or firm of public accountants to the effect that the financial statement presents fairly the position of the corporation and the results of its operations in conformity with generally accepted accounting principles applied on a basis consistent for the period covered thereby, or such other certificate as is in accordance with sound accounting practice.

Summary of Code Requirements

The requirements relating to reporting and disclosure in the corporate annual financial statements are outlined below:

(A) Corporations other than banks shall prepare for stockholders at the annual meeting a financial statement consisting of:

(1) A balance sheet, showing a summary of the assets, liabilities, stated capital and surplus. The amounts of surplus arising from unrealized appreciation of assets, other capital surplus, and earned surplus must be shown separately.

(2) A statement of profit and loss and surplus, showing a summary of profits, dividends paid, and other changes in the surplus accounts. The statement is to cover the period since the last balance sheet.

(B) The financial statement shall have a certificate to the effect that it presents fairly the position of the corporation and the results of its operations in conformity with generally accepted accounting principles applied on a basis consistent for the period covered (or such other statement as is in accordance with sound accounting practice. This certificate is to be signed by the president, vice-president, treasurer or assistant treasurer, or by a public accountant or firm of public accountants.

Discussion

The Code provisions relating to reporting and disclosure are minimal, and according to the opinions of the drafting
committee members who were interviewed, the intent is that the form and content of the reports would be governed by prevailing accounting practice. The balance sheet requirement that surplus be broken down as to that arising from unrealized appreciation, other capital surplus, and earned surplus is new. The former provision merely used the term "surplus" without requiring any information as to its derivation.

Accountants have generally taken the position that the ownership equity should be accounted for in terms of the amounts of capital paid-in or contributed, and the amount earned from operations. The practice has developed of presenting any capital (paid-in) surplus as an addition to the related amount of capital stock, thus indicating the total amount paid in by owners for each class of shares. Despite the present wording used in the Code, which seems to require showing separate totals for each class of surplus, it is believed by the drafting committee members that any presentation of a paid-in capital surplus would be permitted so long as it was properly labeled and could not be confused with stated capital.

The Code specifically states that voluntary contributions of property are to be recorded at their fair values and be reflected as a capital surplus item. The purpose of this

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3 RC, Sec. 1701.32, (surplus).
provision was to make it clear that such contributions were not capital in the legal sense. In light of the fact that capital surplus (paid-in) may be disclosed in such a fashion as to indicate the total contributed capital, presumably a capital surplus arising from voluntary contributions may be accorded a similar treatment. Both the American Institute of Certified Public Accountants and the American Accounting Association have recommended a presentation of all capital received, whether from shares or otherwise, in a single section of the balance sheet.

Accountants, in establishing accountability for corporate assets and their sources, attach considerable significance to earned surplus. Of the total assets displayed on a balance sheet at a particular time, the earned surplus figure represents the portion which has been accumulated from operating activities, as opposed to the amounts obtained from creditors and owners. Where transfers are effected from earned surplus to stated capital, upon the issuance of shares or otherwise, some of the significance of earned surplus is lost once the amount is merged with capital stock. The American Institute of Certified Public Accountants, in recognizing the problem of disclosure of transfers of earnings, has stated that the presentation of retained income (earned surplus) should indicate, so long as is significant, that the amount shown is the remainder after such transfers.

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5 Committee on Terminology, op. cit., pp. 30-31; also Committee on Concepts and Standards, op. cit., p. 4.
6 Committee on Terminology, op. cit., p. 31.
Another, and perhaps more informative, solution lies in accounting for the stated capital in two parts: (1) that which has been derived from contributions from stockholders, and (2) that which has been derived from earnings and, as a result of legal action, is restricted as to disposition. This type of disclosure would indicate clearly the amount of legal capital and at the same time would permit an easy determination of the aggregate earned surplus.

The Code contains no requirements as to disclosure of provisions and conditions which affect surplus as a basis for dividend distributions. The American Institute of Certified Public Accountants (formerly the American Institute of Accountants) stated in an early pronouncement that the nature of any restrictions on surplus should be disclosed on the balance sheet.\(^7\) The Securities and Exchange Commission requires a similar disclosure where the availability of surplus for dividend purposes is materially limited by conditions such as dividend arrearages, involuntary liquidation preferences in excess of par or stated value, and provisions of trust indenture agreements and loan agreements.\(^8\)

The provisions relating to income and surplus are consistent with accepted accounting practice. They require a disclosure

of not only the profit determination and dividends for the period, but also other changes in the surplus accounts as well. Thus analyses of all surplus accounts are required.

The requirements as to the content of the certificate to accompany the annual financial statement is in part in agreement with the type of certificate that independent accountants render. The usual certification of an accountant would state that the accounting principles were "applied on a basis consistent with the preceding period" instead of "for the period covered" as is used in the Code. Furthermore, where accounting procedures have been inconsistent from one period to the next, accounting practice would dictate that the certifying accountant disclose the difference and indicate its effect on the financial position and operating results of the enterprise.⁹

The use of the phrase "in conformity with generally accepted accounting principles" in the certificate presents a somewhat incongruous situation. It would seem that such a certificate could not be made if some of the provisions of the present Code were used. For example, the provisions relating to the application of capital surplus to absorb a deficit, the treatment of losses arising from transactions in a company's own shares, the blanket permission to carry over surplus and to use fair values in all

mergers, and the permission to write up physical assets are not in complete agreement with generally accepted accounting principles.

Evaluation

The Code provisions as to an annual financial statement (consisting of a balance sheet and a statement of income and surplus) represent only minimum requirements and appear to be too general. Furthermore, certain rather essential requirements are omitted.

It would seem desirable if the requirements were revised to include an explicit permission to present the equity in terms of a contributed amount, an earned amount, and other equity amounts, properly disclosed as to origin. This type of a presentation should be made in such a fashion that the amount of legal capital would in no way be obscured. A change of this nature would clear up the present vagueness as to what type of arrangement may be used for the ownership equity without violating the intention of the law.

Three additional provisions would be desirable. One would be a requirement that a disclosure be made of the amounts of surplus (earned or otherwise) transferred to stated capital. Such a disclosure could be accomplished effectively by a parenthetical statement, a footnote, or through the use of additional accounts having descriptive captions. Another provision would be that of requiring disclosure of any conditions which have a material effect on the disposition of surplus. The third would require descriptions of the basic preferences and denials of
of rights attributed to the classes of equity shares. These provisions are necessary to insure the disclosure of pertinent information relating to the ownership equity.

With regard to the certificate that is to accompany the annual financial statement, it would be desirable to require that accounting principles have been applied on a basis consistent with that of the preceding period. Where such principles are inconsistent, disclosure should be required as to the effect of the change on the corporation's current position and operating results.
Chapter VIII
Conclusions

In addition to providing the authority for individuals to use the corporate device for the conduct of business, corporation statutes contain regulatory requirements which are designed to protect the rights and interests of investors. Regulation is necessary due to the fact that the corporation is legally an entity apart from the creditors and owners who have provided the capital with which it operates. Requirements as to accountability and disclosure are a means by which the rights of investors may be safeguarded.

The evaluation of the propriety of any legal requirement must be in terms of the public interest. Since the corporate form of organization is predicated upon an assumption of continuity, it is necessary that there be a permanent division between invested capital and earnings. It is in the public interest that the statutes recognize this distinction in the requirements relating to legal (stated) capital, surplus, dividends and share acquisitions. In addition, these requirements must insure an accurate accountability and disclosure of those transactions which affect the corporate equities.

The following proposals are set forth as the most desirable requirements to be embodied in the corporate code. They stem from considerations of the sources of corporate capital and the resulting equities, proper accountability for transactions, and adequate disclosure of results.
Stated Capital

(A) Stated capital should represent the amount of assets contributed (1) by owners in exchange for shares and (2) by others who retain no direct interest in the enterprise (gifts or donations of property).

(1) Where property other than cash is acquired the amount of stated capital attributable to the contribution should be the fair market value of the property (except in instances of merger or consolidation effected as a pooling of interests).

(2) Since the measure of stated capital is the amount of asset contribution, exchanges and conversions of shares result in neither an increase or decrease in the aggregate stated capital. The conversion of debt securities to shares will increase stated capital by an amount equal to the face amount of the debt.

(B) Stated capital should be attributable to classes of shares and to individual shares. The stated capital of each share outstanding of a particular class should be the average amount paid-in for shares of that class.

(C) Stated capital should be increased upon issue of shares for consideration and transfers from earned surplus (whether accompanied by share issue or not).

(D) Stated capital should be reduced upon the re-acquisition of shares and in instances where formal approval is obtained from shareholders.

Surplus

(A) Surplus should represent the amount of assets derived from earnings and retained in the enterprise.

(1) Additions to surplus would normally result only from earnings and would exclude the so-called "gains" and "losses" arising from transactions in a company's own shares.

(2) Reductions to surplus would come about from losses, asset distributions to owners, and transfers to stated capital.
(B) The elimination of a deficit in earned surplus should be accomplished only upon approval of shareholders to reduce stated capital by an amount equal to the deficit.

Dividends

(A) A dividend should represent a distribution of assets in an amount no greater than earned surplus.

(B) A so-called "share dividend" represents an issuance of shares without consideration and accompanied by a transfer from surplus to stated capital.

(1) The amount of surplus transferred per share should be equal to the average amount paid-in per share, i.e., the stated capital of the shares outstanding prior to the issuance of the share dividend.

(2) A different amount of surplus should be transferred only if required by regulatory agencies such as the Securities and Exchange Commission and the New York Stock Exchange.

(C) Dividends should be prohibited if they are in violation of the rights of other shareholders, if the corporation is insolvent, or if the corporation would be rendered insolvent by payment.

Acquisition of Own Shares

(A) Share acquisitions should represent capital adjustments, whether the shares are reissuable or not.

(1) Upon reacquisition, the stated capital of the corporation should be reduced by an amount equal to the stated capital (average amount paid in) of the reacquired shares. If the outlay is greater than the reduction in stated capital, the excess should be charged to earned surplus.

(2) If reacquired shares are subsequently reissued, they should be accounted for in the same fashion as an original issue.
(B) Share acquisitions (other than redemptions in accordance with the contract of issue) should be limited to an amount no greater than earned surplus. For purposes of dividends, the earned surplus account should be automatically restricted to the extent of the outlay for the shares. If the reacquired shares are subsequently retired, there should be transferred from surplus to stated capital an amount equal to the cost of the shares.

Merger and Consolidation

(A) A merger which is effected by payment of cash and/or issuance of debt securities should be treated as a purchase of the net assets of another company, and any carry-over of the acquired company's surplus should be prohibited.

(B) A merger or consolidation which is effected by the issuance of additional shares should be treated as a pooling of interests, provided there is a continuity of operations after the combination. The surplus accounts of the constituents, to the extent remaining, should be combined in the surviving or new corporation.

(1) The distribution of cash and/or debt securities to the shareholders of the constituent companies represents a reduction of the interests that are being pooled and should be treated as a dividend prior to combination.

(2) Stated capital of the surviving or new corporation should be the same as the aggregate stated capital of the companies being combined.

(C) The assignment of fair market values to the assets of the surviving or new corporation should be restricted to situations in which a "fresh start" is assumed. Where fair market values are used, any carry-over of surplus from the individual companies to the combination should be prohibited.

Reporting and Disclosure

(A) The financial position and operating results of the corporation should be disclosed through
a balance sheet and an income and surplus statement. If other reports such as consolidated statements are necessary for an adequate disclosure, they too should be prepared.

(B) The capital stock section of the balance sheet should reflect the stated capital of the various classes of shares. If the arrangement of the equities is in such a fashion that the aggregate stated capital does not appear as a total, it should be disclosed by a note to the balance sheet.

(C) The classes of shares should be properly described and should include an indication of preferences, denials of rights, and redemption and conversion features.

(D) The amount of any transfers from surplus to stated capital should be disclosed as a subdivision of stated capital or by a footnote.

(E) Disclosure should be made of any restrictions on surplus, such as treasury stock purchases, dividend arrearages, and provisions of loan and indenture agreements which limit dividends.

(F) The financial statements should carry a certificate to the effect that they represent fairly the position and operating results of the corporation, in conformity with generally accepted accounting principles applied on a basis consistent with the preceding period. Where changes in accounting procedure have occurred, disclosure should be made as to the effect of the change on the financial position and operating results of the corporation.
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Autobiography

I, Joseph Ellzey Hampton, was born in Columbus, Mississippi, on March 27, 1922. I was educated in the public schools of Florida, graduating from Miami High School in 1940. My undergraduate training was obtained at the University of Florida. I received the degree Bachelor of Science in 1947. I attended The Ohio State University and received the degree Master of Arts in 1948. I was appointed an instructor in accounting at The Ohio State University in 1952 and have held that position to the present time while completing the requirements for the degree Doctor of Philosophy.