The Creation, Management and Distribution of the Surplus

Surplus May be Defined as the Difference Between the Assets and the Obligations of a Corporation

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In the years 1909-1913, years of high prosperity in Canada, there was an unprecedented merger movement which extended to almost every important business undertaking in this country. On the whole, great economies were effected thereby, both in production and distribution, and to that extent both those directly concerned, as well as the nation at large, benefitted. Nevertheless, when it is recalled that a little more than $57,000,000 worth of securities were placed upon the market as a result of these combinations, it will be realized to what a great extent the managers of Canadian industries were discounting the future. Many of these undertakings—the majority of them—have proved a marked success; but, on the other hand, a number have been compelled to reorganize on a basis whereby the capitalization was made to more closely approximate the real assets. It is unfortunately true that almost all these combinations issued securities up to the full extent of earning capacity, and in some instances far beyond; with the result that it has been almost impossible to guarantee stability of dividends, or meet those emergencies during which earnings have heavily declined. Of course, the war brought about an unprecedented situation, not only among the belligerents in Europe, but in Canada, the United States, Australia and South America as well, during which many well-proved companies were compelled to pass dividends. As in so many other directions in the political life of the nation, the war has proved a relentless revealer of the weak spots in Canada's economic life; and in no particular, perhaps, so much as in the danger incurred by our great industries in failing to build up a surplus to meet contingencies as they arise. Owing, however, to the unprecedented volume of business that has come to Canadian factories during the last two years the situation has been reversed, and the majority of them have now accumulated substantial reserves. It is earnestly to be hoped that these surpluses will not be foolishly dissipated by unwise practices with respect to the payment of dividends and the disposal of reserve funds. As chance revealed the dangerous condition into which many of our large industrial and transportation concerns had got themselves, so chance has given them the opportunity to establish themselves on a firm financial foundation for the future. It is to be hoped that the great opportunity presented to them to attain a strong financial position may not be lost when devising a policy to meet future conditions.

DEFINITION.

Since this article is to deal briefly, and it is hoped clearly, with the surplus, it may be well, first of all, to define precisely what is meant by that term. According to our view of this problem, surplus may be defined as the difference between the assets and the obligations of a corporation — including under "obligations" all the outstanding stock of a corporation, as well as its depreciation and reserve funds and debts. The surplus may have been built up in several different ways — through inheritance, through the selling of stock and bonds above par, through the sale of fixed or semi-fixed assets no longer needed in the business, through a re-valuation of the company's assets, or, above all, by saving.

During the merger period, 1909-1913, when many large combinations were formed in Canada, most of the assets taken over from the constituent companies, were capitalized at their full value; and hence it may be said that very few Canadian companies —outside of the banks—have acquired a surplus through inheritance. Neither have many corporations in this country, at the time they were consolidated out of the various constituent companies, created any considerable surplus by the sale of stocks and bonds above par. A few corporations have disposed of some of their fixed and semi-fixed assets no longer required in the business; but the sums realized in that way have not generally been set aside and ear-marked for surplus account. In only a few cases, and, notably, in connection with our banks, have surplus funds been built up by the re-valuation of assets, or by the bringing into light of concealed assets on the balance sheet. In almost every instance surplus funds have been acquired through the slow, but most desirable process of saving; and it is in that direction that our hopes must be placed in the future for the development and augmentation of surplus funds in connection with the industrial corporations of this country. It may be remarked in passing that the American trusts were in no wise more provident than Canadian industrial combines, with respect to the building up of a surplus, at the commencement of their career. The most notable exception to the general policy pursued is found in the iron and steel concern in which Mr. Andrew Carnegie and Mr. Frick were interested. By following relentlessly the practice of putting back into the business the larger part of the profits earned, Mr. Carnegie built up such a wonderfully productive plant that he was able to sell out to the United States Steel Corporation for $300,000,000 on his own account, as well as for such sums in addition as to make millionaires of many of his associates. The Standard Oil Company is another exception to the general rule that has been followed in the United States, with such results as our readers well know.

A SPECIFIC USE.

Once it has been determined upon to create a surplus, the next point to conisder is the specific use to which it should be put. Should it be regarded mainly as a "rainy day fund" to meet emergencies when earnings fall off, to the end that dividends may be maintained, or should it be put back into the business, according to Mr. Carnegie's plan, to increase earning power? Concerning this problem there is much dispute between two opposing schools of thought among economists and business men in general. The Cunard Steamship Company, as well as the Hamburg-American Line, have followed the former practice, and have set aside each year a considerable part of their earnings as a sort of insurance fund. The Cunard Company has about one-third of its assets invested in securities outside of the steamship business, the object being to draw upon this fund to make up any deficit that may otherwise occur, in years of depression when ocean traffic has fallen off. The theory is, that if the surplus is invested over a wide range of high-class securities, it is hardly likely that income from that source will show a corresponding decline with that in the regular business in which the Cunard Company is directly engaged. This policy undoubtedly makes for permanency in the declaring of dividends; but, on the other hand, it is obvious that, if the surplus is invested in high grade securities, a rate of interest is realized not much higher than can be secured at the bank. Moreover, if a company that follows this practice should ever be forced into liquidation, its creditors—the bondholders—would gain at the expense of stockholders, who are entitled to all that the company can make. This, undoubtedly, is a serious defect in the "rainy day" theory of the management of the surplus, and explains why most companies either distribute the net earnings above expenses of operation, depreciation and reserve, to the stockholders to whom, of course, the whole net income really belongs. This is the policy generally practised by English corporations, and in a few notable instances — especially by the Pennsylvania Railroad — in the United States. On the other hand, most American and Canadian corporations are convinced of the necessity of building up a surplus whether they translate that belief into practice or not.

STRIKING EXAMPLES.

The majority of corporations on this side of the water, which have enough foresight to create a surplus, put it back into the business. The most striking examples in Canada are found in connection with our banks. The Bank of Montreal, the Canadian Bank of Commerce, and the Royal Bank of Canada have each accumulated large surplus funds which they have re-invested in the ordinary business of banking. This has given the three institutions mentioned a commanding position in Canadian finance, and has placed them, indeed, among the strongest financial corporations in the world. It is quite true, of course, that if a corporation following this practice should be forced into liquidation, all surplus funds would be used first for the protection of creditors, and to that extent stockholders would lose. On the other hand, the very fact that large surplus funds are so created, lessens the possibility of such a contingency; while, on the other hand, it enormously increases the company's earning power, since the funds are presumably being used productively and thus earn much more than bank interest. And, finally, and what is of most importance to the stockholder, the surplus is usually returned to him either in the form of higher dividends, in a cash distribution, as a stock bonus, or in subscription privileges. These may now be briefly considered.

It is evident that if a surplus is merely turned back into the business, earnings are made more stable and dividends kept at a steady level or at least made more uniform. In behalf of this practice it may also be pointed out that no individual could hope to make as good use of his share of the surplus fund as the corporation can do for him. We have already drawn attention to the wonderful results achieved by the Carnegie Steel Company through following the policy of turning excess income back into the business. As has been said, when this company sold out to the United States Steel Corporation, almost $500,000,000 were distributed among the fortunate stockholders.

A STOCK DIVIDEND.

The corporation, however, may decide to declare a stock dividend to the end that it may itself retain control of the surplus, but distribute to stockholders all the earnings. As has often been pointed out, stock-watering is quite a different matter from over-capitalizing a company. There is no valid reason why a corporation that can pay eight per cent on each $100.00 par value of stock should not issue two shares on which it will pay a four per cent dividend. It is sometimes forgotten, however, that this may be very desirable from the stockholders' point of view, because two shares at four have a greater speculative value than one share carrying an eight per cent dividend.

A corporation, further, may decide to distribute the surplus by issuing to stockholders of record additional stock at less than the market value of the shares outstanding. This is a practice that has been followed by the C. P. R. in Canada when wishing to raise new capital and at the same time give stockholders a valuable "right" — that is, virtually, a share of the surplus. In this case, the stockholder may decide to buy the stock at the special price and sell later as a speculation; or he may sell "short" and deliver the stock when it is alloted to him. He is also given the opportunity of selling his old holdings and buying new stock with the proceeds; or he may sell his "right" to subscribe to the new stock.

If he buys outright at the special price offered to him, he must, of course, put up cash in the present, and run the risk of the stock declining later on, which it will likely do as no new "rights" will be declared, probably, for a number of years. Moreover, he must run the risk of selling on a falling market. If he adopts the second expedient and sells "short" he may make a large profit, but at the same time must run the risk of being caught in a "corner," especially if he has sold more stock than he has a right to buy. There is far less risk in selling his old stock and exercising his right to buy the new at a special price on a fixed date. There are no disadvantages in connection with this plan as far as ordinary investors are concerned although it may prove decidedly inconvenient for stock market operators who have posted their old stock as collateral for a loan. Taking things all in all, therefore, most stockholders will prefer to hold their old stock and sell the "right" to subscribe to new stock at a special price. What the value of that "right" should be on the market is a question that must be held over for later consideration. It is our present intention merely to draw attention to the imperative necessity on the part of all our corporations — whether industrial, commercial or financial — to create a surplus not only to the end that dividends may be maintained, but that the business may be placed on such a firm foundation that it can meet any contingency that may arise.

LESS TEMPORARY EMPLOYMENT.

Returns from twelve city corporations as to the number of employees temporarily employed in the first fortnight of the month and the wages paid such employees show a decline in the number of workers on the pay rolls and an increase in the amount of wages paid. The number of temporary employees was 9,814, and the wages paid $260,887.08, as compared with 10,460 and $241,413.46, respectively, in January, indicating that a smaller number of workers was more steadily employed than in the previous month. This condition is evident from the returns of Montreal, Ottawa, Hamilton, Winnipeg and Victoria, and also in Halifax, Edmonton and Vancouver, as the increase in the amount of wages paid in these cities is much greater than the increase in the number of employees. At Regina and Moose Jaw, increases in both the number of employees and the wages paid are indicated, while Toronto and Calgary show declines in both cases.