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Emerging concept of income presentation

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AN EMERGING CONCEPT OF INCOME PRESENTATION

Abstract: This article reviews the development of income presentation found in the authoritative accounting pronouncements since 1941. During this period, within the historical cost reporting model for presentation of income, emphasis has shifted from the all-inclusive concept of net income and the current operating performance concept to a hybrid approach which substantially incorporates the two concepts.

Income measurement presents an imprecise evaluation of the results of business activity. Despite its limitations, the importance of income measurement is well established in the financial accounting literature.[1] Two extreme positions are apparent in a study of the alternative methods of determining and presenting income within the historical cost model. These are commonly identified as the all-inclusive and the current operating performance concepts.

Advocates of the all-inclusive approach to income determination and presentation have defined net income

> . . . according to a strict proprietary concept by which it is presumed to be determined by the inclusion of all items affecting net increase in proprietorship during the period except dividend distributions and capital transactions[2]

On the other hand, advocates of the current operating performance concept of income placed

> . . . principal emphasis upon the relationship of items to the operations, and to the year, excluding from determination of net income any material extraordinary items which are not so related or which, if included, would impair the significance of net income so that misleading inferences might be drawn therefrom.[3]

The purpose of this article is to review the development of income presentation through the authoritative pronouncements since 1941. In a period of about 35 years an evolution has occurred from a position of the all-inclusive concept to the extreme opposite position of current operating performance and then back to a hybrid concept, near the all-inclusive concept.

The heart of the controversy was whether special items such as extraordinary items and prior period adjustments should be given different treatment from normal operating items. An awareness of the evolution of these approaches is helpful in understanding the currently-accepted position on income presentation. This history also shows the way in which generally accepted accounting principles can change over time in the United States. Furthermore, a study of the evolution of these approaches to income determination should shed some light on the "income smoothing" controversy.

THE PERIOD OF THE ALL-INCLUSIVE INCOME STATEMENT

In Accounting Research Bulletin (ARB) No. 8, issued in 1941, the Committee on Accounting Procedures (CAP) demonstrated a definite preference for the all-inclusive income concept:

> . . . Over the years it is plainly desirable that all costs, expenses, and losses of a business, other than those arising directly from its capital stock transactions, be charged against income. If this principle could in practice be carried out perfectly, there should be no charges against earned surplus, except for distributions and appropriations of final net income. This is a theoretical ideal upon which all may agree, but because of conditions impossible to foresee, it often fails of attainment. From time to time charges are made against surplus which clearly affect the cumulative total of income for a series of years, even if their exclusion from the income statement of the current year is justifiable. . . . The committee recognizes the great importance of distinguishing between charges against income and charges against earned surplus. It does not here undertake to define proper charges against earned surplus. For purposes of this statement it simply takes cognizance of the fact that such charges are from time to time found to be a necessary though perhaps debatable feature of accounts. It approves the current tendency to discourage such charges whenever possible.[4]

The CAP, however, failed to address the basic issues of specifying the nature of profit and loss items and defining charges which might properly be made to retained earnings.[5] This lack of distinction contributed to the emergence of the combined statement of income and retained earnings which was sanctioned by the CAP in ARB No. 8. Littleton appears to reflect the feelings of the CAP when he commented on the combined statement, stating that its purpose was ". . . to avoid the conclusion that recurring income is the only element that matters."[6] Littleton went on to indicate that by the issuance of a combined statement, all the modifications to retained earnings would appear on one statement despite the fact that in accounting practice substantial differences existed as to what was placed on the income statement and what was placed on the retained earnings statement.

During the next several years, statements were issued by the CAP which reduced variety in the measurement and reporting of net income. ARB No. 23 provided that income tax should be related to the items giving rise to it. Hence, income tax related to items not included on the income statement would not enter into a determination of net income. ARB No. 28 defined contingency reserve and recommended that provisions to such reserves not be made from net income. ARB No. 31 dealt with "Reserves for Future Declines in Inventory Prices" and concluded that inventory reserves are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income. In financial circles the terms "operating" and "non-operating" income and charges emerged without an official distinction having been made between the two.

In ARB No. 32, issued in 1947, the CAP reiterated the position of ARB No. 8 that all items of profit and loss recognized during the period should be used in determining the figure reported as net income. However, items which in the aggregate were material in relation to net income and were clearly not identifiable with usual or typical business operations were to be excluded from net income. Net income was to be clearly designated and special items were either to follow that amount on the income statement or were to be presented in the statement of retained earnings. No preference was expressed for either method.

Acceptance of charging or crediting special items directly to retained earnings as well as presenting them in the income statement indicates a tolerance for both the current operating performance and all-inclusive approaches to income. In the event such items were placed on the income statement, however, they were to *follow* the amount labeled as net income. Thus, the item net income was a figure resulting from an application of the current operating approach to income.

The three dissents to ARB No. 32 argued ". . . that the so-called 'all-inclusive' concept provides the proper measure of net income and best serves the public interest because it is least subject to reader misinterpretation."[7] These three members of the 21-member committee viewed the position of ARB No. 32 as being such a radical change from the preferred all-inclusive position of the past that they dissented to its issuance.

These developments point toward the desire to include all items of profit and loss in income determination but at the same time to present an indication of the results of "normal" business activities. This struggle was to continue, as indicated in the next section.

THE PERIOD OF THE CURRENT OPERATING PERFORMANCE INCOME STATEMENT

Corporate profits reached a new high in 1947 but to a substantial extent the profits were a result of inflation.[8] A large number of companies recognized the impact of inflation on profits and decided to reduce profits by appropriations for possible future price declines or inventories, for increased replacement costs of fixed assets, and for losses of a contingent and indefinite nature which might be expected to follow a period of price advances. Substantial deductions were made directly on the income statement in determining 1947 profits. Income reduced by the provision was most frequently reported in the financial media and was sometimes labeled net income and other times not labeled net income. Amounts of the appropriations were so substantial that serious concern was expressed both within and outside the profession.

ARB No. 35, issued in 1948, reflected the CAP's acceptance of a current operating performance philosophy. Net income was to be presented without deductions or additions resulting from (a) general purpose contingency reserves, (b) inventory reserves, (c) extraordinary items, and (d) excessive costs of fixed assets and annual appropriations in contemplation of replacement of production facilities at high price levels. The last and most prominent figure on the income statement was to be the number reflecting the results of the year's operating performance.

ARB No. 41, which was issued in 1951 as a supplement to ARB No. 35, was somewhat of a softening of the strong current operating performance position of the earlier bulletin. Between the times of issuance of ARB No. 35 and ARB No. 41, the Securities and Exchange Commission (SEC) issued a regulation providing for the inclusion at the bottom of the income statement of items of profit and loss recognized for the period but not included in net income. The CAP subsequently altered its position to make this method acceptable but at the same time stated a preference for the current operating performance presentation whereby special items were carried directly to retained earnings. If special items were to be included on the income statement, net income was to be designated so as not to be confused with the final figure on the statement. Representations of earnings for the year or earnings per share were to be based on net income. Thus, the number labeled as net income continued to be that resulting from the application of the current operating approach to income.

In the 1953 restatement of former Accounting Research Bulletins, ARB No. 43, Ch. 8 reemphasized the position taken in ARB Nos. 35 and 41. A slight change in wording indicates a greater tolerance than before for the presentation of special items in the income statement although the CAP strongly preferred their inclusion in the statement of retained earnings.

The period of 1948 to 1953 was clearly a time when the current operating approach to income determination found support by the AICPA. Whether or not special items were included in the income statement, the number labeled as net income was to be that resulting from their exclusion. It is apparent that there was concern over users placing undue reliance on a single income figure, and the idea of a dual income presentation emerged during this period.

THE EVOLUTION TOWARD A HYBRID INCOME PRESENTATION

After the restatement of former Accounting Research Bulletins in 1953, no significant statement on income presentation was issued until 1966 when the Accounting Principles Board (APB) issued its Opinion (APBO) No. 9. The period of 1953 to 1966 was one in which there developed a multiplicity of income presentations.

An examination of reporting practices for these years in *Accounting Trends and Techniques* reveals a greater number of alternative presentations than might be implied by the dual concepts of all-inclusive and current operating performance. Tables I, II, and II summarize the various ways in which special items were presented during the period and depict the great variation in financial statement presentation.

The majority of special items were presented in the income statement with the manner of presentation varying considerably. Special items were found in three places: (a) among other income and cost items but separately disclosed, (b) aggregated with other income and cost items but reported through footnotes and other descriptive disclosures such as the president's letter, and (c) in separate income statement sections. A further difference in presentation existed among those items included in a separate statement section in that in some instances this section appeared before net income and in others after net income. Data on the location of this section within the income statement are not available prior to 1960. It is important to recognize that special items given these treatments were still not precisely defined.

A review of the location of items in the income statement and the retained earnings statement for the period 1953 to 1966 is presented in Table 1. During this period both the number of companies re-

TABLE I

FREQUENCY OF SPECIAL ITEMS

Year	Number of Companies Reporting	Number of Special Items Reported	Location of Special Items	
			% in Income Statement	% in Retained Earnings Statement
1966	119	162	70%	30%
1965	174	250	78	22
1964	187	252	76	24
1963	203	264	76	24
1962	234	369	74	26
1961	222	312	79	21
1960	230	324	81	19
1959	213	280	88	12
1958	232	322	86	14
1957	184	257	88	12
1956	240	289	88	12
1955	327	398	77	23
1954	315	324	79	21
1953	345	391	80	20

Source: Based on *Accounting Trends and Techniques* for the years 1954 through 1967.

porting special items and the number of those items declined significantly. There was a strong tendency to present special items in the income statement.

Table II reviews the disclosure of special items in the income statement. A very definite trend existed toward the presentation of items in a separate statement section and away from the two alternatives of footnote and other descriptive disclosure and inclusion among other income and cost items. One may speculate that the drastic change in 1966 resulted from the exposure of APBO No. 9 in 1966 and the anticipation of its publication which occurred in December of that year. It became effective for periods beginning *after* December 31, 1966, and required the separate section disclosure following "Net Income Before Extraordinary Items" and preceding "Net Income."

For the period 1960 to 1966 information is available on the location within the income statement of the separate section for special

TABLE II

PRESENTATION OF SPECIAL ITEMS IN INCOME STATEMENT

Year	Total Number of Items Presented in Income Statement	Disclosure in Income Statement: % Among Other Income and Cost Items	% in Separate Section	% in Footnotes or Other Description
1966	114	21%	72%	7%
1965	196	47	46	7
1964	192	51	41	8
1963	201	44	50	6
1962	273	44	37	19
1961	246	46	41	13
1960	263	46	36	18
1959	246	47	32	21
1958	277	42	39	19
1957	226	47	36	17
1956	254	58	32	10
1955	306	56	24	20
1954	257	64	27	9
1953	314	59	18	23

Source: Based on *Accounting Trends and Techniques* for the years 1954 through 1967.

items (Table III). While the percentages vary considerably, more special items were presented before rather than after net income.

At least two conclusions may be drawn from this review of reporting practices of the period 1953 to 1966. There appears to have been a strong preference for the all-inclusive income presentation, and reporting practices varied significantly from that recommended by the AICPA. An approximation of the relative use of the two concepts of all-inclusive and current operating performance is presented in Table IV. This analysis relates only to the latter part of this period since data on the location of a separate income statement section (before and after "net income") is not available prior to 1960. Also, 1966 data were not included in the analysis since reporting practices of that year may reflect an anticipation of APBO No. 9. During this period (1960-1965) some 65% of special items appeared to have been presented under an all-inclusive concept of income and 35% under a current operating performance concept.

ARB No. 43, issued in 1953, expressed strong preference for the current operating performance presentation and required in cases where special items were included on the income statement, that the amount labeled as net income be that computed before special items. To a great extent, however, companies did not follow this recommendation as the majority of special items appeared in the income statement either merged with other costs and expenses,

TABLE III

PRESENTATION OF SPECIAL ITEMS IN SEPARATE INCOME STATEMENT SECTION

Year	Number of Items Reported in Separate Section	Location of Separate Section: % of Items Presented Before "Net Income"	Location of Separate Section: % of Items Presented After "Net Income"
1966	82	57%	43%
1965	90	41	59
1964	79	49	51
1963	100	53	47
1962	102	66	34
1961	102	68	32
1960	94	87	13

Source: Based on *Accounting Trends and Techniques* for the years 1961 through 1967.

TABLE IV

USE OF ALL-INCLUSIVE AND CURRENT OPERATING PERFORMANCE CONCEPT 1960-1965

	% of All Special Items Presented (Average)
All-Inclusive Concept:	
Income Statement Presentation—Among other income and cost items	36%
Income Statement Presentation—Footnote or other descriptive disclosure	10
Income Statement Presentation—Separate section before "net income"	19
	65
Current Operating Performance Concept:	
Income Statement Presentation—Separate section after "net income"	12
Retained Earnings Statement Presentation	23
	35
	100%

Source: Based on *Accounting Trends and Techniques* for the years 1961 through 1966.

separately disclosed by footnote or other descriptive disclosure, or in separate sections *before* the number labeled as net income.

The increasing importance placed on net income, coupled with the widespread dissemination of financial information in the 1950's and early 1960's prompted the APB to reexamine the multiple methods of income presentation extant at that time. A major element of concern, in addition to the statement location of special items, was the lack of definitive descriptions of extraordinary items and prior-period adjustments in light of the significant impact these two factors had on income under the various reporting practices being followed.

The basic position of the APB was that income should reflect all items of profit and loss recognized during the period except prior period adjustments. As to statement form, two income figures were to be placed on the statement, "Income Before Extraordinary

Items," and "Net Income," with extraordinary items (less the applicable tax effect) coming between them.

In describing extraordinary items, the dual criteria of unusual and non-recurring were combined with materiality as follows:

> Such events and transactions are identified *primarily* by the nature of the underlying occurrence. They will be of a character significantly different from the typical or customary business activities of the entity. Accordingly, they will be events and transactions of material effect which would not be expected to recur frequently and which would not be considered as recurring factors in any evaluation of the ordinary operating processes of the business. (Emphasis added.)[9]

In describing prior-period adjustments four criteria were established, all of which must exist for an event to qualify for exclusion from the income statement: (a) The event can be specifically identified with and directly related to the business activities of particular prior periods; (b) The event is not attributable to economic events occurring subsequent to the date of the financial statements for the prior period; (c) The event depends primarily on determinations by persons other than management; and (d) The event was not susceptible to reasonable estimation prior to its determination.

These conclusions in APBO No. 9 follow from the concern that users may place undue reliance on a single income number and the desire to state income on the basis of normal business operations. It also indicates a clarification on the difference between an extraordinary item and a prior period adjustment, the first time such a specification had been made.

The concept of a prior period adjustment was extended in post-APBO No. 9 pronouncements. In APBO No. 20, *Accounting Changes,* the proper reporting of a correction of an error in previously issued financial statements is that of a prior period adjustment.[10] The same concept has been evident in recent Financial Accounting Standards Board Statements which require retroactive application of newly adopted accounting standards.[11]

APBO No. 9 illustrates a definite movement toward an all-inclusive concept of income. First, extraordinary items were made a necessary part of income determination and presentation by the requirement that they be placed on the income statement. Second, the amount on the income statement labeled "net income" was defined as the number resulting from the addition or deduction of extraordinary items from operating income. Thus, "net income" was the result of an application of the all-inclusive concept of income (with the exception of prior period adjustments) rather than the current operating performance concept as had been required under the former Accounting Research Bulletins. Third, while prior period adjustments were excluded from income statement presentation (an application of the current operating performance concept), they were defined so specifically that the APB concluded that ". . . such adjustments are rare in modern accounting."[12]

Because of differences in interpretation, various problems arose in the application of APBO No. 9.[13] First, the lack of a definition of materiality for extraordinary items led to a difference among firms as to what constituted an item large enough to warrant separate disclosure as an extraordinary item. Second, the terms "unusual or customary activity" and "non-recurring" were too general to encourage uniform application in practice. Third, size appeared to have been a major consideration in evaluating the extraordinary status of an item without due regard for the nature and recurrance of an item. Fourth, companies provided separate disclosure of "unusual" transactions although the transactions did not fit the criteria for extraordinary. Such presentation led, in some cases, to the inclusion of an additional income figure, such as "net income before unusual items" which appeared before both of the income figures described in APBO No. 9. Fifth, the practice of offsetting extraordinary gains of a period with provisions for future losses, thereby relieving future periods of charges which ordinarily would be made against them, existed.

Public discontent with the variety in practice of reporting extraordinary items expressed itself in several ways. The New York Stock Exchange was considering reporting guidelines whereby "extraordinary" items would be included as a part of current operating income and their extraordinary nature explained in footnotes to the financial statements. The SEC expressed concern over the large increase of extraordinary items in annual reports, particularly large charges to current income which may have been costs accumulated over prior years. Reporting practices of the years 1967 to 1972 and reaction to these practices led to a further refinement of income presentation by the APB in 1973.

In APBO No. 30 the APB further refined the concepts underlying income presentation. The resulting net income figure was based primarily on the all-inclusive concept. However, prior-period adjustments are excluded from the statement and an additional income figure, based on the current operating performance concept, is included in the presentation. In addition, a more specific definition of extraordinary items was posited, and items which are unusual in nature or not frequently recurring but not both were made part of the net income before extraordinary items figure.

APBO No. 30 requires the presentation of discontinued operations as a component of net income before extraordinary items. This is in contrast to APBO No. 9 which indicated that the sale or abandonment of a plant or a significant segment of the business was a legitimate extraordinary item.

The new figure of "net income from continuing operations" is based on the concepts of current operating performance income and going concern. To stress the importance of this measure of income, the opinion requires computations of earnings per share on income from continuing operations in the same manner as for net income before extraordinary items and net income.

In defining extraordinary items in APBO No. 30, the Board was very specific in stating that *both* the criteria of unusual nature and infrequency of occurrence must be met. The requirement that the "unusual" and "infrequency" criteria be evaluated in light of the environment in which the entity operates further restricts the number of events which may qualify as extraordinary. An additional listing of items which ordinarily should not be classified as extraordinary items restricted the application of the concept of extraordinary items from that of APBO No. 9 (e.g., gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations, and other gains or losses from sale or abandonment of property, plant, or equipment used in the business).

At least two notable exceptions remain to the above generalizations concerning the proper classification of items are found in the cases of tax loss carry-forwards and gains and losses from extinguishment of debt. APBO No. 11 specifies that loss carryforwards should not be recognized until they are actually realized except in unusual circumstances. When the tax benefits of loss carryforwards are not recognized until realized in full or in part in subsequent periods, the tax benefits should be reported as an extraordinary item in the results of operations of the period in which realized.[15]

A second exception from the criteria of APBO No. 30 results from action of the FASB Statement of Financial Accounting Standard No. 4. According to this pronouncement, material gains and losses from extinguishment of debt that are to be included in the determination of net income should be aggregated and classified as extraordinary.

They are to be shown net of applicable tax and per share amounts of the aggregate net gain or loss should be disclosed.[16]

The final step to the current position of income presentation came in 1977 when the FASB issued its statement No. 16, *Prior Period Adjustments*. The position taken eliminates prior period adjustments as described in APBO No. 9, indicating that all items of profit and loss recognized during the period should be included in the determination of net income for the period.[17] The only exceptions to this general principle are corrections in errors in previously-issued financial statements and adjustments resulting from realization of income tax benefits of pre-acquisition loss carryforwards of purchased subsidiaries. The change in presentation required by this statement represents another significant step toward the all-inclusive income presentation.

CONCLUSION

As accounting practices have been refined over the past 35 years, within the historical cost reporting model for presentation of income, emphasis has shifted from the all-inclusive concept of net income and the current operating performance concept to a hybrid approach which substantially incorporates the two concepts. Each pronouncement's contribution to this hybrid concept of presentation is summarized in Table V.

Numerous influences have brought income presentation to its present hybrid form. One influence was a concern that the user would place undue reliance on a single income figure. This resulted in a number of labels for income being included in the income statement over time with a major question being the location of extraordinary items among those income figures. Another influence was the desire to display a figure related to "normal operations" while still holding to the all-inclusive concept. A third influence was the need to define special items which eventually led to the sharp distinction between prior period adjustments and extraordinary items and the further delineation of the disposal of a segment.

The all inclusive concept of ARB 8 proved to be unacceptable because of the lack of definition of the special items and a vehicle for disclosing them. On the other hand, the current operating concept proved to be unacceptable for a similar reason. Abuses in the designation of items to exclude from the determination of net income led to refinement in definition of these items and their presentation in the statements in a manner such that users can make predictions

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TABLE V

PROVISIONS OF ACCOUNTING RESEARCH BULLETINS AND ACCOUNTING PRINCIPLES BOARD OPINIONS

	ACCOUNTING RESEARCH BULLETINS					APB OPINIONS	
	8 (1941)	32 (1947)	35 (1948)	41 (1951)	43 (1953)	9 (1966)	30 (1973)
1. Discourages adjustments to retained earnings	YES	NO	NO	NO	NO	YES	YES
2. Recognizes a distinction between ordinary and extraordinary items on the income statement	NO	YES	NO	YES	YES	YES	YES
3. Recognizes a distinction between extraordinary items and prior period adjustments	NO	NO	NO	NO	NO	YES	YES
4. States that extraordinary items must appear on the income statement rather than on retained earnings statement	NO	NO	NO	NO	NO	YES	YES
5. Includes extraordinary items in item labeled "net income"	YES	NO	NO	NO	NO	YES	YES
6. Excludes a current operating income figure from the income statement	YES	YES	NO	YES	YES	NO	NO

about future net income. The current model provides for inclusion of virtually all items in the income statement yet appropriate disclosures that enable a statement user to appreciate the current performance of operations.

FOOTNOTES

[1]APB Statement No. 4, p.70; *Objectives of Financial Statements*, pp.24, 26, 34, 36-39.

[2]ARB No. 32, 1947, p.260.

[3]ARB No. 32, 1947, p.260.

[4]ARB No. 8, 1941, p.64.

[5]In 1941 the CAP recommended discontinuance of the use of the term surplus in favor of the term retained earnings or some other descriptive title. Throughout this paper the term retained earnings is used except in direct quotes where the CAP used the term earned surplus.

[6]Littleton, p.36.

[7]ARB, No. 32, p.265.

[8]Broad, p.378.
[9]APB Opinion No. 9, pp.114-115.
[10]APB Opinion No. 20, pp.398-399.
[11]FASB Statements No. 8, No. 11, No. 12.
[12]APB Opinion No. 9, p.116.
[13]Berstein, pp.57-61.
[14]Lipay, pp.21-22.
[15]APB Opinion No. 11, pp.173, 179.
[16]FASB Statement No. 4, pp.3-4.
[17]FASB Statement No. 16, p.5.

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