Income and earned surplus; Accounting Research Bulletin, no. 32

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Income and Earned Surplus

1. For a number of years the committee has studied the form and content of financial statements and has considered the means by which they may be made more useful for the purposes they are designed to serve. As a result of this inquiry, and taking cognizance of the expanded public use of corporate financial data, the committee believes it appropriate to issue this statement

(a) citing briefly the viewpoints with respect to the principal debatable area of the income statement, and

(b) recommending criteria for use in identifying material extraordinary charges and credits which may or should be excluded from the determination of net income.

2. In dealing with the problem of selecting the most useful form of income statement, the danger of understatement or overstatement of income must be recognized. An important objective of income presentation should be the avoidance of any policy of income equalization.

3. The committee directs particular attention to certain facts which serve to emphasize that the word "income" is used to describe a general concept, not a specific and precise thing. Initially, it is important to iterate that the income statement is based on the concept of the "going-concern." It is at best an interim report. Profits are not fundamentally the result of operations during any short period of time. Allocations as between years of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions, they sometimes are large in relation to the other amounts in the income statement.

4. It must also be recognized that the ultimate distinction

between "operating" income and charges and "non-operating" gains and losses, terms having considerable currency in the accounting profession, has not been made. The former are generally defined as recurrent features of business operation, more or less normal and dependable in their incidence from year to year; the latter are generally considered to be irregular and unpredictable, more or less fortuitous and incidental. The committee is also mindful that the term "net income" has been used indiscriminately and often without precise, and most certainly without uniform, definition in the financial press, investment services, annual reports, prospectuses, contracts relating to compensation of management, bond indentures, preferred stock dividend provisions, and in many other places.

5. In the committee's view, the above facts with respect to the income statement and the income which it displays, make it incumbent upon readers of financial statements to exercise great care at all times in drawing conclusions from them.

6. The question of what constitutes the most practically useful concept of income for the year is one on which there is much difference of opinion. On the one hand, net income is defined according to a strict proprietary concept by which it is presumed to be determined by the inclusion of all items affecting the net increase in proprietorship during the period except dividend distributions and capital transactions. The form of presentation which gives effect to this broad concept of net income has sometimes been designated the "all-inclusive" income statement. On the other hand, a different concept places its principal emphasis upon the relationship of items to the operations, and to the year, excluding from the 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. This latter concept would require the income statement to be designed on what might be called a "current operating performance" basis, because its chief purpose is to aid those primarily interested in what a company was able to earn under the operating conditions of the period covered by the statement.

7. Proponents of the "all-inclusive" type of income statement insist that annual income statements taken for the life of an enterprise should, when added together, represent total net income. They emphasize the dangers of possible manipulation of annual earnings if material extraordinary items may be omitted in the determination of income. They also assert that, over a period of years, charges resulting from extraordinary events tend to exceed the credits, and their omission has the effect of indicating a greater earning performance than the corporation actually has exhibited.

They insist that an income statement including all income charges or credits arising during the year is simple to prepare, is easy to understand, and is not subject to variations resulting from the different judgments that may be applied in the treatment of individual items. They argue that when judgment is allowed to enter the picture with respect to the inclusion or exclusion of special items, material differences in the treatment of borderline cases will develop and that there is danger that the use of "distortion" as a criterion may be a means of rationalizing the normalization of earnings. With full disclosure of the nature of any special or extraordinary items, this group believes the user of the financial statements can make his own additions or deductions more effectively than can the management or the independent accountant.

8. Those who favor the "all-inclusive" income statement largely presume that those supporting the "current operating performance" concept are mainly concerned with establishing a figure of net income for the year which will carry an implication as to future earning capacity. Having made this presumption, they contend that income statements should not be prepared on the "current operating performance" basis because income statements of the past are of only limited help in the forecasting of the earning power of an enterprise. This group also argues that items reflecting the results of unusual or extraordinary events are part of the earnings history of the corporation, and accordingly should be given weight in any effort to make financial judgments with respect to the company. Since a judgment with respect to the financial affairs of the corporation should involve a study of the results of a period of prior years, rather than of a single year, this group believes that the omission of material extraordinary items from annual income statements is undesirable as it would tend to cause them to be overlooked in such a study.

9. On the other hand, those who advocate the "current operating performance" type of income statement generally do so because they are mindful of the particular business significance which a substantial number of the users of financial reports attach to the income statement. They point out that, while some users of financial reports are able to analyze a statement and eliminate from it those unusual and extraordinary items that tend to distort it for their purposes, many users are not trained to do so. Furthermore, they contend it is difficult at best to report in any financial statement sufficient data to afford a sound basis upon which the reader who does not have an intimate knowledge of the facts can make a well considered classification. They consider it self-evident that management and the independent auditors are in a stronger position

than outsiders to determine whether there are unusual and extraordinary items which, if included in the determination of net income, may give rise to misleading inferences with respect to current operating performance. Relying on the proper exercise of professional judgment, they discount the contention that neither managements nor the independent auditors, due to the absence of objective standards to guide them, have been able to decide consistently which extraordinary charges and credits should be excluded in determining earning performance. They admit it is hazardous to place too great a reliance on the net income as shown in a single annual statement and insist that a realistic presentation of current performance must be taken for what it is and should not be construed as conveying an implication as to future accomplishments. The net income of a single year is only one of scores of factors involved in analyzing the future earnings prospects or potentialities of a business. It is well recognized that future earnings are dependent to a large extent upon such factors as market trends, product developments, political events, labor relationships, and numerous other factors not ascertainable from the financial statements. However, this group insists that the net income for the year should show as clearly as possible what happened in that year under that year's conditions, in order that sound comparisons can be made with prior years and with the performance of other companies.

10. The advocates of this "current operating performance" type of statement join fully with the so-called "all-inclusive" group in asserting that there should be full disclosure of all material charges or credits of an unusual character, including those attributable to a prior year, but they insist that such disclosure should be made in such a manner as not to distort the figure which represents what the company was able to earn from its usual or typical business operations under the conditions existing during the year. They point out that many companies, in order to give more useful information concerning their earning performance, make it a practice to restate the earnings of a number of prior years after adjusting them to reflect the proper allocation of items not related to the years in which they were first reported. They believe that material extraordinary charges or credits may often best be disclosed as direct adjustments of surplus. They point out that a charge or credit in a material amount representing an unusual item not likely to recur, if included in the computation of the company's annual net income, may be so distorting in its results as to lead to unsound judgments with respect to the current earning performance of the company.

11. The committee has previously indicated[1] that, in its opinion,

[1] See Accounting Research Bulletins Nos. 8 and 23.

it is plainly desirable that over the years all profits and losses of a business be reflected in net income, but at the same time has recognized that, under appropriate circumstances, it is proper to exclude certain material charges and credits from the determination of the net income of a single year, even though they clearly affect the cumulative total of income for a series of years. In harmony with this view, **it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period.** Thus, only extraordinary items such as the following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom:[2]

(a) Material charges or credits (other than ordinary adjustments of a recurring nature) specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;[3]

(b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals;

(c) Material losses of a type not usually insured against, such as those resulting from wars, riots, earthquakes and similar calamities or catastrophes except where such losses are a recurrent hazard of the business;

(d) The write-off of a material amount of intangibles, such as the complete elimination of goodwill or a trademark;

(e) The write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement or refunding of the debt before maturity.[4]

Adjustments resulting from transactions in the company's own capital stock, amounts transferred to and from accounts representing a

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[2] See Accounting Research Bulletin No. 23 with respect to the allocation of income taxes.

[3] To the extent that the recommendations contained in this statement are in conflict with those contained in summary statement (5) and the footnote thereto in Bulletin No. 23, this Bulletin supersedes that Bulletin.

[4] To the extent that the recommendations contained in this statement are in conflict with Bulletin No. 18, this Bulletin supersedes that Bulletin.

segregation or appropriation of surplus or general contingency and inventory reserves such as those dealt with in Bulletins 28 and 31, and adjustments made pursuant to a quasi-reorganization, should be excluded from the determination of net income under all circumstances.

12. Consideration has been given to the method of presentation of the extraordinary items that are excluded in the determination of net income under the criteria set forth in the preceding paragraph. Some would carry all such charges and credits directly to the surplus account with complete disclosure as to their nature and amount. Others would report most of those items at the bottom of the income statement immediately following the amount of net income and include them in the determination of the amount carried to surplus.[5] The committee expresses no preference for either of these methods, but is of the opinion that, regardless of the form of presentation, the amount of net income should be clearly and unequivocally designated.

13. In its deliberations concerning the nature and purpose of the income statement, the committee has been mindful of the disposition of even well-informed persons to attach undue importance to a single net income figure and to "earnings per share" shown for a particular year. The committee directs attention to the undesirability in many cases of the dissemination of information in which major prominence is given to a single figure of "net income" or "net income per share." However, if such income data are reported (as in newspapers, investors' services, and annual corporate reports), the committee strongly urges that any determination of "income per share" be related to the amount reported as net income, and that where charges or credits have been excluded from the determination of net income, the corresponding total or per share amount of such charges and credits also be reported separately and simultaneously. In this connection the committee earnestly solicits the cooperation of all organizations, both governmental and private, engaged in the compilation of business earnings statistics from annual reports.

The statement entitled "Income and Earned Surplus" was adopted by the assenting votes of eighteen members of the committee, of whom one, Mr. Himmelblau, assented with qualification. Three members, Messrs. Chamberlain, Paton, and Stans, dissented.

Mr. Himmelblau assents with the qualification that when the figure designated as "net income" precedes special charges and credits

[5] Neither of these methods precludes the use of the combined statement suggested in Accounting Research Bulletin No. 8.

in the income statement, the caption should be expanded to read "net income before special charges and credits"; he believes the more specific description is needed to prevent the phrase being quoted separately from its context in which case misleading inferences may arise. Likewise, he believes the balance after special charges and credits should be given an adequate descriptive title.

Messrs. Chamberlain, Paton, and Stans dissent from the conclusions of this bulletin because they believe 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. They believe that all of the aims of both schools of thought described herein can be accomplished by a two-section form of income statement in which net operating income is segregated from the non-operating gains or losses and the sum of the two sections is reported as "net income for the year." They are willing to accept the criteria in subparagraphs (a) to (e) of paragraph 11 for the purpose of establishing the items to appear in the second section of such an income statement. However, Mr. Chamberlain points out that with respect to the first of the criteria, his concept of the all-inclusive statement calls for the return of unused special purpose reserves in the year in which it is first determined that the reserves are not needed; also, he is opposed to the elimination of general contingency reserves through the income account on the ground that their creation did not properly give rise to an income charge. Subject to this explanation of his views with respect to subparagraph (a) of paragraph 11, Mr. Chamberlain joins Messrs. Paton and Stans in contending that recognized gains and losses of the types described are part of the business history and should not be permitted to be carried to a separate surplus statement but should be included in the income account, in juxtaposition to the operating result. They believe that the bulletin will not materially reduce the present number of surplus charges and credits, a practice which they condemn on the ground that it results in incomplete historical reporting and thereby tends to hinder public understandability of financial statements.

NOTES

1. *Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report*

of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

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