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No. 39

Recommendation of
Subcommittee on Terminology

Discontinuance of the Use of
the Term "Surplus"

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FOREWORD

The committee on accounting procedure has approved as an objective the recommendation of the subcommittee on terminology made herein with respect to the discontinuance of the use of the term "surplus" in accounting, and has authorized its publication. The statements herein contained, however, are not to be regarded as pronouncements of the committee on accounting procedure.

RECOMMENDATION OF SUBCOMMITTEE ON TERMINOLOGY

In a report of the committee on terminology, issued in September, 1941, as Research Bulletin No. 12 (Special), it was recommended that consideration be given to the feasibility of a general discontinuance of the use of the word *surplus* in accounting. Since that time there has been extensive discussion of the proposal, and some companies have used other terms in their financial statements. The present subcommittee on terminology of the committee on accounting procedure has considered the matter and its conclusions are set forth herein.

A factor of primary importance in the balance-sheet presentation of the stockholders' equity is the status of ownership at the balance-sheet date. Where two or more classes of stockholders are involved, the interests of each must be presented as clearly as possible. These interests include the entire proprietary capital of the enterprise, which is conventionally divided further, largely on the basis of source, as follows:

1. Capital stock, representing the par or stated value of the shares.¹

¹ In some states the term "capital stock" has been replaced by the term "stated capital" which represents the par or stated value of shares, or the consideration received upon the issuance of shares.

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2. Capital surplus, representing (a) capital contributed for shares in excess of their par or stated value², or (b) capital contributed other than for shares.
3. Earned surplus, representing accumulated earnings or the remainder of such earnings at the balance-sheet date.

While the terms *capital surplus* and *earned surplus* have been widely used, they are open to serious objection.

1. The term *surplus* has a connotation of excess, overplus, residue or "that which remains when use or need is satisfied" (Webster), whereas no such meaning is intended where the term is used in accounting.
2. The terms *capital* and *surplus* have established meanings in other fields, such as economics and law, which are not in accordance with the concepts which the accountant seeks to express in using those terms.
3. The use of the term *capital surplus* (or as it is sometimes called, *paid-in surplus*) gives rise to confusion. If the term *surplus* is intended to indicate capital accumulated by the retention of earnings, i.e., retained income, it is not properly used in the term *capital surplus*. Further, if the term *surplus* is intended to indicate a portion of the capital, there is an element of redundancy in the term *capital surplus*.
4. If the term *capital stock* (and in some states the term *capital surplus*) be used to indicate capital which, in the legal sense, is restricted as to withdrawal, there is an implication in the terms *surplus* or *earned surplus* of availability for dividends. This is unfortunate because the status of corporate assets may well be such that they are not, as a practical matter, or as a matter of prudent management, "available for dividends."

It seems highly desirable, therefore, that an effort be made to find terms more nearly connotative of the ideas which are sought to be expressed.

In seeking such terms consideration should be given primarily to the *sources* from which the proprietary capital was derived. In addition regard should be had for certain types of events which may

² This classification includes such items as capital transferred from capital stock account as a result of the reduction of par or stated value, and credits resulting from transactions in the corporation's own stock.

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have occurred in the history of the corporation. Thus a quasi-reorganization in which a "new start" has been made, may be said to have put the entire net assets, as restated at the time, into the status of contributed capital, while that part of capital now conventionally described as *earned surplus* would include only earnings retained thereafter and would be "dated" accordingly. Likewise a stock dividend, or a transfer by resolution of the board of directors, must be dealt with as a transfer of capital accumulated by retention of earnings to the category of restricted capital for purposes of subsequent presentation. Finally, the classification of proprietary capital involves a consideration of present status in such matters as contractual commitments, dividend restrictions and appropriations of various kinds.

RECOMMENDATION

In view of the foregoing the subcommittee recommends that, in the balance-sheet presentation of the stockholders' equity:

1. The use of the term *surplus* (whether standing alone or in such combination as *capital surplus*, *paid-in surplus*, *earned surplus*, *appraisal surplus*, etc.) be discontinued.
2. The contributed portion of proprietary capital be shown as:
 - (a) Capital contributed for, or assigned to, shares, to the extent of the par or stated value of each class of shares presently outstanding.
 - (b) Capital contributed for, or assigned to, shares in excess of such par or stated value (whether as a result of original issue of shares at amounts in excess of their then par or stated value, reduction in par or stated value of shares after issuance, or transactions by the corporation in its own shares), and capital received other than for shares, whether from shareholders or others.
3. The term *earned surplus* be replaced by terms which will indicate source, such as *retained income*, *retained earnings*, *accumulated earnings*, or *earnings retained for use in the business*. In the case of a deficit, the amount will be shown as a deduction from contributed capital with appropriate description.
4. In connection with 2 (b) and 3 there should, so far as practicable, be an indication of the extent to which the amounts have been appropriated or are restricted as to withdrawal. Retained

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income appropriated as a reserve nevertheless remains part of retained income, and any reserves which are clearly appropriations or segregations of retained income, such as reserves for general contingencies, possible future inventory losses, sinking fund, etc., should be included as part of the stockholders' equity.

5. Where there has been a quasi-reorganization, retained income should thereafter be "dated," and where, as a result of a stock dividend or a transfer by resolution of the board of directors from unrestricted to restricted capital, the amount of retained income has been reduced, the presentation thereafter should indicate that the amount shown is the remainder after such transfers.
6. Any appreciation included in the stockholders' equity other than as a result of a quasi-reorganization should be designated by such terms as *excess of appraised or fair value of fixed assets over cost* or *appreciation of fixed assets*.

SUBCOMMITTEE ON TERMINOLOGY

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