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# HISTORICAL vs. EARNING POWER CONCEPT OF THE INCOME STATEMENT

Panel Discussion

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## THE INCOME STATEMENT

Income statements required to be filed with the Commission under the 1933 and 1934 Acts are not obtained to gratify a desire on the part of the Commission for information as to the business of publicly owned companies. Financial data is required under these Acts in order to get information for investors and to get it under sanctions and administrative review designed to secure a degree of reliability and informativeness that was unfortunately not attained theretofore. In administering these Acts the policy has been to prescribe, for the most part, broad standards rather than detailed, rigid rules and forms, to encourage recognition of the circumstances and peculiarities of particular businesses, in short to avoid the Procrustean bed.

Quite naturally, however, there are some precise requests for specific information. The general permission contained in Rule 3-01 of Regulation S-X to adapt the form, order and content of statements to the business is not to be construed as authority for omitting specific items called for by the rules. As a result, proposals for new or revised forms of statements that would omit data specifically called for cannot be put into practice, so far as filings with the Commission are concerned, without revision of the existing rules.

With this as a background, I may turn to this evening's exploration of the income statement. The preceding speakers have ably

outlined a large part of the current thinking about the basic principles underlying the income statement. To a considerable degree they have seemed to be in agreement, so much so that their differences may appear minor rather than basic, a matter of emphasis rather than substance. On the level of theoretical discussion this is perhaps so; at the level of case by case application I think the differences between the "historical" and the "earning power" approach are marked and of fundamental importance.

There can be little doubt that investors are more interested in the future than in the past. In their efforts to forecast the future they are, however, wholly dependent on the events of the past as a start for appraising the future. To serve that end satisfactorily, the financial record of the past clearly ought to be so cast up as to be as helpful a guide to the future as possible. So far everyone is in agreement. But here the two approaches diverge. Those supporting the earning power or earning capacity approach attach to management and their accountants the duty of arriving at a figure for annual income or loss which in their opinion is a fair measure of the results of the regular operations for the year. The more radical of these would even exclude from the income statement the effects of any and all events which in their opinion were not involved in or part of the regular operations of the year's business. However, most of them, perhaps, would cause some part of these items to be put in a final section of the income statement following the item of net income from regular operations. Those who support the historical approach would, on the other hand,

require almost all events of the year involving a profit or loss to the company to be reflected in the profit and loss statement. They would place upon management and their accountants the duty of full disclosure, of describing and classifying the items in such a way as to make clear their ordinary or extraordinary nature, but they would not require or invite, as a part of the statement, a representation that there was a figure of "net earnings for the year from regular operations" that somehow was to be considered of more importance, or more permanence, or more realness than the final net profit or loss after taking into account all transactions involving a profit or loss.

The earning capacity approach has a good deal to recommend it, as Mr. Grady has so forcefully pointed out. Certainly, management and its accountants are often in the best position to judge the likelihood of recurrence of certain events. They clearly will know why an unusual transaction was entered into -- for example, a bond refunding or a sale of property. They probably have the best available information as to impending corporate events. In short, they are in a preferred position to gauge the bearing of general and special factors on the particular business.

On the other hand, the concept of an earning capacity figure derived exclusively from the regular operations of the year is subject to some very important and inherent weaknesses. As Mr. Peloubet has implied, non-recurring and extraordinary items do have a bearing on estimates of future earnings. Indeed, a very large part of these

so-called non-recurring items are merely items that either were not or could not be allocated to the regular operations of any particular year. Emphasis of an "earning capacity" figure which by hypothesis excludes the effects of such items glosses over one of the major limitations of the accounting process and in the long run may bring it into disrepute. The barest reference to the accounting practices of earlier years will call to mind almost innumerable cases in which earnings were reported year after year by companies which never seemed to be able to pay dividends or to accumulate an earned surplus. And there will continue to be such situations so long as accountants are liberal in excluding items from the income statement and support propositions such as these: that prospective losses on investments and long term assets need be given no current recognition whatever and that any realized losses on sale of such assets may go to surplus because they are "unusual" or are "allocable to past years."

One of the major arguments relied upon by those who advocate the earning capacity approach is that "the average investor looks only at the final figure of net income for the year" or indeed "only at the published figure of net earnings per share." From this premise the conclusion is drawn that it is necessary, to avoid misconceptions, to arrive at a figure of net income for the year that is "representative," that is not affected by profits or losses or events which in the judgment of the management and its accountants are extraordinary or non-recurrent. In passing, it may be noted that from such a stand it is but a short

step to another and clearly outlawed area — equalized earnings. Even avoiding that step, the soundness of the conclusion is very debatable. Earning capacity is not in fact a succession of normal or regular years, but the result of a series of years whether normal or abnormal.

A succession of "normalized" or "regularized" net incomes particularly when the investor is assumed to look only at the final figure shown for regular annual net income cannot fail to give the impression that earnings may be expected to be regular; of indefinite duration and of a given size. And the more regularized is each year's income the more clearcut is that impression. Consequently, normalization, that is, the omission of chronic abnormalities, actually is deceptive in two respects -- it tends to give an undue impression of regular, recurrent earnings and it discourages or prevents the investor from making his own appraisal of what is "abnormal" and what is not.

Finally, the "earning capacity" approach invites a pretty wide and treacherous group of adjustments or allocations. Grant that a decision can be logically made that a sale of unused real estate -- even though acquired for the business and subsequently discarded — is non-recurrent. Grant that the loss on sale of a subsidiary is not wholly due to or part of this year's operations. Grant that there will not be a refunding of bonds every year, nor will there often an uninsured plant burn down. Nevertheless, all of these events are a part of the corporate activities. They did occur in a particular year. Decisions involving such events were not reached in a vacuum, or in contemplation of only

one of the interrelated factors. To illustrate, the rate of taxes is involved in a decision to sell at a loss — but so is the fact that there is expected to be a very large taxable income. How then can one adamantly say that a tax saving is attributable to the loss? Why not say a good deal more simply and, I think, logically, that an unusual loss was taken at a time when profits were unusually large? What is wrong or misleading or unrealistic in netting the two and showing the tax as levied on the balance, the effective income for the year? It seems to me that only on the basis of many arbitrary assumptions can we pull apart the skein of the year's activities and events so as to isolate a particular transaction and say with assurance "here is something that had no relation to the rest of the year's activities and can be excluded." Particularly today it seems to me we might well think about taxes and the so-called tax savings somewhat as follows: "This year's revenues are unusual; this year's profits are unusual; this year's tax rates are unusual; as a result an unusual loss or transaction was put through and there results an unusual tax savings due to unusual tax rates due to the unusual profits of an unusual year."

To sum up, it is my personal feeling on the evidence so far presented that the historical approach is in general more realistic, more useful and in the long run less deceptive. Mere adoption of either approach, however, does not end the problem of the income statement. Under either view much remains to be done with respect to such problems as these:

1. What can be done to provide a workable accounting mechanism to give current recognition to long term losses?

2. What can be done in accounting to disclose the effect of abnormal conditions on the regular operations section of the income statement -- as an illustration, consider maintenance, which today in dollar volume may be proportionate to previous years but which may nevertheless be definitely substandard in a physical sense.

3. What should be done, accountingwise, to give recognition in the publication of statements to the foreseeable effect on the future of current events that were not effective in the period covered by the statements?

4. Is the form of income statement now generally used physically satisfactory, and, if not, does the so-called single-step form really offer any promise of being more understandable and subject to less misconstruction because it contains no analytical subtotals or balances?

5. Should statements for use by investors be ~~functionalized~~ socialized -- that is, should they, for financial and investment purposes, ~~be socialized and~~ reflect the division of costs by social ~~groups~~ categories - labor, capital, and government?

The problem of the income statement is not so different from that of the map maker. A 16th century map bears little resemblance to its present day counterpart. And a flat map is surprisingly little

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like a modern air map. No doubt draftsmen of 16th century maps indulged themselves in much argument as to the proper reflection of the information available to them. Doubtless they accepted slowly and cautiously, even reluctantly, new evidence as to what the facts really were. No doubt today many schooled in the usual flat maps refuse to believe that air maps present a "true" picture.

Accountants find themselves in somewhat the same position. One of the most difficult tasks is to sort a group of conflicting suggestions into those which represent progress and those which do not, and then to overcome caution and inertia to the extent necessary to adopt them. This evening's meeting is a part of that process.

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