1-1-1929

Report of special committee on definition of earned surplus

American Institute of Certified Public Accountants. Special Committee on Definition of Earned Surplus

AMERICAN INSTITUTE OF ACCOUNTANTS

COUNCIL

To the Members and Associates of the
American Institute of Accountants:

Gentlemen:

The council of the American Institute of Accountants resolved that the report presented by the special committee on definition of earned surplus at the meeting of September 16, 1929, be printed in pamphlet form and sent to the entire membership. It is the will of council that in presenting this report to the membership attention be directed to the important nature of the report and that a request be made that every member and associate give the substance of the report careful consideration.

Will you kindly read and consider the report submitted herewith and present your suggestions in writing? It will be helpful if you will respond as soon as you can do so.

By Order of the Council,
A. P. Richardson,
Secretary.

September 30, 1929.

REPORT OF SPECIAL COMMITTEE ON DEFINITION OF EARNED SURPLUS

To the Council of the American
Institute of Accountants:

Gentlemen:

As reported under date of September 10, 1927, your special committee on the definition of earned surplus found from an examination of the statutes of the various states governing the payment of dividends that, by reason of lack of uniformity and uncertainty of the interpretation of ambiguous provisions, the present laws furnish no satisfactory basis for the definition of earned surplus available for dividends; and from a study of the procedure followed by accountants in their certificates and reports, that there is a distinct lack of uniformity among the members of the profession.

Your committee, therefore, recommended that it be authorized to prepare and submit to the members of the Institute a questionnaire designed to furnish a basis for the recommendation of standard practice relating to the presentation of surplus accounts. The replies to this questionnaire indicate a rather wide divergence of opinion on many of the questions submitted, but after a study of the replies, due consideration having been given to the majority opinion that seemed to be expressed as well as to the apparent intent of the replies, your committee recommends the following definition of earned surplus, together with certain collateral definitions and a standard of practice in the presentation of surplus accounts.

DEFINITION OF EARNED SURPLUS

Earned surplus is the balance of net profits, income and gains of a corporation from the date of incorporation (or from the date of recapitalization when a deficit was absorbed by a reduction of the par or stated value of the capital stock) after deducting losses and after deducting distributions to stockholders and transfers to capital-stock accounts when made out of such surplus.

COLLATERAL DEFINITIONS

Surplus in its broadest sense is the amount of the stockholders' equity in a corporation in excess of that represented by capital-stock accounts. Capital surplus comprises paid-in surplus, donated surplus and revaluation surplus—that is, surplus other than earned surplus. Paid-in surplus is the amount received from the sale or exchange of stock in excess of the par or stated value thereof and includes surplus arising from a recapitalization. Donated surplus includes donations by stockholders or others of cash, property and capital stock. Revaluation surplus is the appreciation recognized as arising from the appraisal of fixed assets.

The unqualified terms "surplus" and "capital surplus" are not recommended as adequate captions for balance-sheet purposes.

STANDARD PRACTICE IN PRESENTATION OF SURPLUS ACCOUNTS

Profits arising from the sale or other disposition of fixed assets or from the resale of the corporation's own capital stock (not including donated stock) are properly included in earned surplus. A disclosure, however, should be made in the year of the transaction when the amounts appear to be relatively significant.

Extension and improvement reserves, reserves for the retirement of corporate securities and other appropriated earned-surplus items, although not available for distribution to stockholders, are properly shown as subdivisions of earned surplus on the balance-sheet. Where it is provided that retirements of a preferred stock or bond issue are to be made "out of earnings" and where it is the intent of the provision that earnings of an equivalent amount are to be retained in the business, such earnings should be segregated and distinguished on the balance-sheet from unappropriated earned surplus.

Earned surplus is not properly consolidated with capital-stock accounts on the balance-sheet without specific corporate action authorizing such procedure.

Where dividends, losses and expenses (other than organization expenses, unamortized discount on a bond issue retired under a plan of recapitalization, commissions and discounts on sale of capital stock and amounts paid in the purchase of capital stock in excess of the par or stated value thereof) are charged against capital surplus a disclosure should be made.

Where a corporation states its fixed properties on the basis of appraisal values which exceed the former book values, depreciation computed on the appraisal values should be charged against operations and no transfer from revaluation surplus to earned surplus should be made. The necessity for this procedure is emphasized where the appraisal and the surplus created as a result thereof have formed a part of the representations made in connection with an issue of securities senior to the common stock still outstanding, or where the corporation has in any way legally or morally obligated itself to maintain the assets at their increased valuation out of earnings.

Surplus of a subsidiary corporation accumulated prior to the date of the acquisition of its stock by a parent corporation is not a part of consolidated earned surplus. A dividend declared out of such surplus by a subsidiary is applicable by the parent corporation as a reduction of its investment in the subsidiary.

Occasions will arise where the practice as herein set forth cannot be strictly complied with, due to conflict with state laws and with agreements between a corporation and its bankers or investors. In that event the problems of providing for adequate disclosures in the balance-sheet are involved and necessarily must be dealt with according to the special factors presented in each case. A disclosure may be general or specific and it may be limited to the year of the transactions or continued, according to the relative amount and significance of the item.

It is recommended that your committee be continued for another year, in order that it may have an opportunity of considering the opinions which are likely to be expressed following the publication of this report and of embodying in a supplemental report such additional interpretative and explanatory comments as may appear advisable.

Respectfully submitted,

ARTHUR ANDERSEN, *Chairman*
ERIC L. KOHLER
JNO. MEDLOCK
P. W. PINKERTON
JOHN A. STOLP

Chicago, Illinois,
September 10, 1929.