

ON DISPOSABLE INCOME

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I. *Distinction Between Capital and Income*

The term income is used in various ways, for example, income which should be separated from capital, income available for dividends, disposable income, distributable income, and so forth. Some of these variations are used as accounting terms, some as legal terms, and some as managerial terms.

This paper is written to explain the relationships among these concepts concerning income.

"The distinction between capital and income, which every one recognizes and the economist attempts to state with refined accuracy, is fundamental in accounting."¹ This is the first sentence of *A Statement of Accounting Principles* by Sanders, Hatfield and Moore, a book which heralded the so-called movement for uniformity of accounting principles in America, and which seems to have greatly affected to *Kigyo Kaikei Gensoku* (the Business Accounting Principles) in Japan.

However, when the distinction between capital and income is discussed, the definitions of these two terms are not always the same. For example, some say that, out of proprietorship, only capital stock and capital surplus are considered capital, and that appropriated surplus and unappropriated surplus—that is, retained income—are considered income, as well as net income for a given period.

Such an interpretation is seen in the following statement of Dr. Katsuji Yamashita, which deals with the distinction between capital accounting and income accounting in connection with the area and problem of capital accounting. According to Dr. Yamashita, there are two kinds of transactions which cause change in stockholders' equity; one is the use of capital as well as the transaction closely connected with it,² and the other the transaction not related to the use of capital.³ The former is in the area of income accounting, and the latter is in that of capital accounting.⁴ Though he seems to be almost silent as to the difference between stockholders' equity and the capital which should be separated from income, and the difference between the results arising from the use of capital and the income which should be separated from capital, such an inference may be drawn from his argument that capital accounting deals with "capital adjustments" and that income accounting deals with "disposable earned income."⁵

¹ Thomas Henry Sanders, Henry Rand Hatfield and Underhill Moore, *A Statement of Accounting Principles*, 1938 New York, p. 1.

² Katsuji Yamashita, *General Theory of Accounting*, Chikura-shobō, in Japanese, 1959, p. 40.

³ Katsuji Yamashita, *op. cit.*, p. 40.

⁴ Katsuji Yamashita, *op. cit.*, p. 197.

⁵ Katsuji Yamashita, *op. cit.*, p. 197.

Such a view is most clearly expressed in Dr. Yasutaro Tamba's statement that the requirement for continuous maintenance of distinction between capital and income is met by not confusing capital (in its narrow sense) with retained income and that, therefore, the income which should be separated from capital must not be regarded as only periodic income, but also as retained income.⁶

On the other hand, there is another possible interpretation. According to this interpretation, only the net income for the period is considered as income which should be separated from capital; and hence retained income as well as capital stock and capital surplus is included in the capital which should be separated from income. For instance, Professor Tadashi Nakamura may be regarded as speaking from this standpoint. He says, in connection with the scope of capital accounting, that, in corporate enterprises, capital is the total proprietorship including capital stock, capital surplus and earned surplus.⁷ The former interprets the distinction between capital and income as distinguishing so-called paid-in capital from the sum of periodic and retained income. The latter interprets it as distinguishing the periodic income from the capital used to earn it.

The difference between these two interpretations seems to arise from the difference of recognition as to the nature or function of income. That is, the difference is based on the fact that the former considers income as what is disposable, while the latter considers it as what is available for judging the results of operations for a particular period. Setting aside for a while any discussion as to whether the income computed to fulfill one of these two functions may perform the other function and also have the nature of the other simultaneously, let us consider the subject of enterprise accounting. Business must be operated efficiently, so as to be able to maintain the operating capacity. Enterprise accounting, as well as managerial planning, performance and control, and their organizations, is also required to serve this purpose. That is, accounting should calculate the figure which is useful for judgment of the results of a business operation, and should distinguish clearly between what is disposable and what is non-disposable out of proprietorship. Therefore, in accounting, two kinds of distinction between capital and income are required: one is the distinction between periodic income and the proprietorship used to earn it; and the other is the distinction of paid-in capital from the sum of retained and periodic income, in which case the proprietorship used is divided into paid-in capital and retained income. This relation is shown as follows.

capital		income	
paid-in	capital	retained	income
capital		income	
		periodic	income

Thus, in accounting, the distinction between capital and income has two meaning and both distinctions must be considered. However, it is the income which should be separated from paid-in capital that is dealt with in law or business administration, particularly in financial management. Hereafter the income which should be separated from paid-in capital will be called retained income, as against periodic income, and it will be the crux of further discussion.

Now, what is retained income, and how is it determined?

⁶ Yasutaro Tamba, *Capital Accounting*, Chuōkeizai-sha, in Japanese, 1957, pp. 49-50.

⁷ Tadashi Nakamura, *Capital Accounting*, Hakutō-shobō, in Japanese, 1961, p. 6.

II. *Retained Income and Its Determination*

In accounting, income or income determination is usually considered as periodic income or periodic income determination. This is based on the fact that in modern accounting the stream of money, goods and services of going concern is usually divided into period of one year. But it should be noted that the retained income is the portion of proprietorship available for distribution at a particular date, and in this sense it is not the so-called periodic income but the income at a particular date.

There is some connection between periodic income and retained income, for the amount of periodic income for the first period of business is equal to that of income which should be separated from the paid-in capital at the end of the same period, and in any other period, if there is no retained income or deficit at the beginning of the period, the amount of periodic income coincides with that of income which should be separated from paid-in capital. But such a case is rather rare and usually both incomes do not coincide.

The retained income at a particular date is the sum of periodic incomes from the opening of the enterprise up until that particular period, less (a) the sum of periodic losses and (b) what was distributed as, dividends, officers' bonuses, etc. during the same period. Therefore, if income emerges in one period, the retained income increases on the contrary, and in the case of a loss, the retained income decreases. Retained income is related to periodic income like this.

There are two methods of retained income determination: one is the method which emphasizes the nature of retained income as the income at a particular date; and the other is the method of determining retained income by adding the periodic income for the period to the retained income up to the previous period. These two methods are considered individually.

One of the methods of income determination is that of comparing the amount of net worth at two different dates. Under this method, the income is determined by comparing the amount of net worth at the beginning of a period with that at the end of the same period, i. e.,

$$\begin{aligned} \text{Periodic Income} &= \text{Net Worth at the Beginning of a Period} \\ &\quad - \text{Net Worth at the End of a Period} \dots\dots\dots(1) \end{aligned}$$

This is the method which compares the amount of net worth at the basic date with that of present net worth. In the determination of retained income, the amount of net worth at the basic date is the amount of net worth at the opening of business, and hence retained income is determined as follows:

$$\begin{aligned} \text{Retained Income} &= \text{Net Worth at a Particular Date} \\ &\quad - \text{Net Worth at the Opening of Business} \dots\dots\dots(2) \end{aligned}$$

But this equation cannot always be applied. To make this equation applicable, there must be some premise that additional contributions or returns of capital, or any other changes in net worth not associated with the utilization of resources did not occur during the period. Additional contributions cause the increase in net worth, but the amount of it should not be distributed to the outside. Net worth decreases as a result of returns of capital, but it does not affect retained income. Accordingly, (2) can be applied when there is no change arising

from capital adjustments. To be a general equation, (2) must be altered as follows:

$$\text{Retained Income} = \text{Net Worth at a Particular Date} - (\text{Net Worth at the Opening of Business} + \text{Total Increase from Capital Adjustments after the Opening of Business} - \text{Total Decrease from Capital Adjustments after the Opening of Business}) \dots\dots\dots(3)$$

There is another way of periodic income determination which compares the revenues of a given period with the expenses to be matched with such revenues. This method is shown as follows:

$$\text{Periodic Income} = \text{Periodic Revenue} - \text{Periodic Expense} \dots\dots\dots(4)$$

From the standpoint of retained income determination, it does not matter, whether revenues and expenses are normal or extraordinary, or whether they are associated with current operations or are adjustments applicable to prior periods, for in spite of the above differences, all revenues and expenses are equal since they augment or diminish the income which is disposable to the outside. Therefore, in the determination of retained income, it is not necessary to keep them distinct according to the aforementioned difference. Thus what is important here is not the so-called current operating performance income, but the all-inclusive income, in the determination of which all revenues and expenses including adjustments to prior years are counted. If periodic income is determined on the basis of current operating performance, it will be different from all-inclusive income the sum of the adjustments to earned surplus during the period, arising from other than the appropriation of profits and its correction.

From this point of view, retained income is the sum of all-inclusive income from the opening of business to a particular period, less the total income distributed to the outside:

$$\text{Retained Income} = \text{Total Periodic Incomes Based on All-Inclusive Theory} - \text{Total Income Distributed to the Outside} \dots\dots\dots(5)$$

The following equation is obtained from (4) and (5).

$$\text{Retained Income} = (\text{Total Periodic Revenues} - \text{Total Periodic Expenses}) - \text{Total Income Distributed to the Outside} \dots\dots\dots(6)$$

Thus we have two methods of retained income determination: one is that of using (3), the other that of using (6). In the equation (3), there is no difficulty in measuring the amount of net worth at the beginning of business, but the valuation of net worth at a particular date and the recognition of the increases or decreases of capital after the opening of business present a difficult problem in accounting. Needless to say, the net worth is the difference between assets and liabilities. Therefore, in determining the amount of net worth, the valuation of assets becomes especially important. If assets are overvalued, the retained income based on (3) is increased and periodic expenses in (6) are understated, which also causes the overstatement of retained income. If assets are undervalued, the influence is quite the reverse.

On the contrary, factors in (6) sometimes affect factors in (3). For instance, the understatement of depreciation charges results in the overstatement of depreciable assets or the amount of depreciable assets carried forward to the following period, and this brings about the increase of retained income. By the overstatement of bad debts, accounts and notes receivable are undervalued, and retained income is decreased by as much. This is the reason why the fair measurement of expenses and the fair valuation of assets are required.

Moreover, of those matters which cause the changes in net worth, we must distinguish clearly between increases of net worth itself and revenues or decreases of net worth itself

and expenses. Without these distinction, we cannot expect the fair determination of retained income or income disposable to the outside, however fairly assets may be valued or expenses may be measured. In other words, we must draw a sharp line between charges or discharges of capital surplus and those of revenue or earned surplus.

It is not impossible to measure retained income in connection with periodic income, as shown in (6). But, as stated above, the retained income is essentially the income at a particular date. So we cannot determine retained income in all cases by using an income statement. With the income statement of a particular period only, retained income cannot be determined except for some special case referred to previously. To determine the retained income, all income statements and appropriation of earned surplus statements from the opening of business to a particular period are necessary. Without these data, it is impossible to determine retained income, for an income statement is nothing but a statement of periodic income.

However, we can determine retained income if the balance sheet is available. It may be said that retained income is determined in the balance sheet. (3) may be expressed as follows:

$$\text{Net Worth at a Particular Date} = \text{Assets at the Particular Date} - \text{Liabilities at the Particular Date} \dots\dots\dots(7)$$

$$\begin{aligned} &\text{Net Worth at the Opening of Business} + \text{Total Increase of Net Worth} \\ &\text{Itself after the Opening of Business} - \text{Total Decrease of Net Worth} \\ &\text{Itself after the Opening of Business} = \text{Capital Stock at the Particular} \\ &\text{Date} + \text{Capital Surplus at the Particular Date} \dots\dots\dots(8) \end{aligned}$$

If we introduce (7) and (8) in (3), we get the following equation:

$$\text{Retained Income} = (\text{Assets} - \text{Liabilities}) - (\text{Capital Stock} + \text{Capital Surplus}) \dots\dots(9)$$

If we arrange these items as follows:

$$\text{Assets} = \text{Liabilities} + \text{Capital Stock} + \text{Capital Surplus} + \text{Retained Income} \dots\dots(10)$$

This is just so-called the balance sheet equation. Thus retained income is determined in the balance sheet, although in the balance sheet, retained income in (10) is divided into appropriated earned income and unappropriated earned surplus; and unappropriated earned surplus is subdivided into earned surplus carried forward to the following period and net income for the period.

III. *Income Available for Dividends*

As above mentioned, a business enterprise can maintain the operating capacity even if all retained income is distributed to the outside. However, from the legal point of view, not all of retained income is available for dividends, for, while the distinction between paid-in capital and retained income is a matter of theory, the propriety of the distribution of capital or income is a matter of policies. Even income is not always distributable. In this sense, income available for dividends is not repetition of retained income.

Next, let us consider the income available for dividends in the Commercial Code of Japan. The Commercial Code of Japan was amended in April, 1962, primarily centering to the provisions of the valuation of assets, and came into force on April 1, 1963. Before the amendment, the commercial code provided that in the determination of income available for dividends, the amount of surplus reserve already set aside and the amount to be newly set aside shall

be deducted from retained income. The intention of this provision is to strengthen capital for the purpose of protecting creditors whose claims are secured only by corporate assets. In this case, no capital reserve and no loss brought forward from the previous period are required to be deducted from retained income, for, though the scope of capital surplus in (9) does not coincide with that of capital reserve in the commercial law, the former is a broader conception which connotes all items included in the latter, and the amount of capital reserve has already been deducted in the determination of retained income. As to the loss brought forward, the reason is that the net worth of a particular date in (2) or (3) is the residual after the loss was deducted.

The question is whether or not the amount of voluntary reserve set aside on the basis of the provision of the by-law or the decision of the general meeting of stockholders is subtracted from retained income in the determination of income available for dividends. Originally, unavailability for dividends means that corporate assets should not be distributed as dividends to the outside under a restriction for some special purposes. By the deduction of the amount of capital stock and capital surplus from that of corporate assets in the determination of retained income, that part of the corporate assets is restricted which corresponds to capital stock or its equivalent. Likewise, by the deduction of the amount of surplus reserve in the determination of income available for dividends, that portion of corporate assets is restricted and retained in the enterprise. If so, it follows that in principle the amount of the voluntary reserve for a particular use which is intended to restrict the corporate assets to that special purpose and to prevent them from being used for other purposes must be deducted from the amount of corporate assets in the determination of income available for dividends. But, of the voluntary reserve for a special use, it seems that such a reserve as dividend equalization reserve need not be deducted, because it is the reserve which restrict corporate assets for dividend purpose. The amount of the voluntary reserve having no special purpose must be subtracted from retained income in the determination of income available for dividends. Therefore, it is not always proper to say that all voluntary reserve is available for dividends or, to the contrary, that all voluntary reserve should be deducted in the determination of income available for dividends. Accordingly, the amount of earned surplus carried forward to the following period constitutes income available for dividends.

Therefore, the income available for dividends in the commercial law before the amendment was made is calculated as follows:

$$\text{Income Available for Dividends} = \text{Retained Income} - \text{Surplus Reserve (including the amount to be reserved)} - \text{Voluntary Reserve (excluding the reserve for dividend purpose)} \dots\dots\dots(11)$$

If we introduce (9) in (11), we get the following equation:

$$\text{Income Available for Dividends} = (\text{Assets} - \text{Liabilities}) - (\text{Capital Stock} + \text{Capital Surplus} + \text{Surplus Reserve} \llcorner \text{including the amount to be reserved} \gg + \text{Voluntary Reserve} \llcorner \text{excluding the reserve for dividend purpose} \gg) \dots\dots\dots(12)$$

Since surplus reserve and voluntary reserve are lumped under appropriated earned surplus, (12) can be altered as follows:

$$\text{Income Available for Dividends} = (\text{Assets} - \text{Liabilities}) - (\text{Capital Stock} + \text{Capital Surplus} + \text{Appropriated Earned Surplus} + \text{The Amount to be Set Aside as Surplus Reserve} - \text{The Amount Reserved for Dividend})$$

Purpose)(13)

Capital Surplus in (12) includes capital reserve in the commercial law, revaluation reserve, and other capital surplus such as governmental subsidy for capital expenditure and contributions in aid of construction. If we give such a legal consideration, the equation (12) will be as follows :

Income Available for Dividends=(Assets—Liabilities)—{Capital Stock+
(Capital Reserve+Revaluation Reserve+Other Capital Surplus)+
(Surplus Reserve «including the amount to be reserved »+Voluntary
Reserve «excluding the reserve for dividend purpose »)}.....(14)

It should be noted, however, that in the revised commercial code which has been effective since April 1, 1963, it is provided that, in the determination of income available for dividends, if the sum of the amount outlaid for the purpose of preparation for commencement of business and the amount especially outlaid for research of new products or new technique, development of new resources, adoption of new technique and exploitation of new markets listed in the section of assets in the balance sheet exceeds the sum of capital reserve and surplus reserve (including the amount to be reserved), the excess amount should be further deducted from the amount of the net worth. The propriety of such a procedure will be examined in the next section.

IV. *Disposable Income*

The income available for dividends above-mentioned is determined by deducting the amount which restricts the corporate assets primarily under the legal requirements of the income essentially distributable in full which was separated from paid-in capital. Therefore, it is distributable to the outside from the accounting or legal point of view. However, it is not always disposable in reality. In the actual disposition of income, we must consider another restriction of corporate assets, i. e., working capital. It is true that, unless there are assets, especially current assets corresponding to income available for dividends, we cannot distribute income—including dividends—to the outside. But it is more important not to impair working capital with assets corresponding to income distributed to the outside. Enterprise income is the fund representing the claim for dividends, drawing, etc., and, to meet this condition, it must be represented by working assets realizable without loss during a normal period. Again, it is required, for example, that the amount of working capital used for the first period be available for the transaction of a subsequent period. As a result, some portion of retained income is actually not distributable to the outside. Thus it should be noted that “*profit earned*” and “*profit available*” for the distribution to the outside are not the same.⁸ Therefore, of retained income, the maximum amount distributable to the outside is the balance to be obtained after the deduction of the amount of necessary funds from that of the corporate assets, free from the restriction of current liabilities, i. e., that of working capital.

Various views are represented dissenting from the procedure of the revised commercial law in Japan which establishes the restriction of dividends as a part of deferred assets as above-mention, thus treating the deferred assets differently from legal assets. Based upon the intrinsic nature of income, such views are correct. However, since that part of income

⁸ P. Taggart, *Profits and Balance Sheet Adjustments*, London 1934, p. 7.

which corresponds to deferred assets is not based on working capital, the view of the revised commercial law can be accepted from the standpoint of financial policy, regardless of the propriety that the law should give such a financial consideration.

Retained income is fundamentally obtained by comparing net worth or comparing total revenues with total expenses. Therefore, even if it is wholly distributed to the outside, net worth at the basic point will still be maintained. Even if all income available for dividends, obtained by deducting the amount of appropriated earned surplus other than the reserve for dividend purpose from the amount of retained income, is distributed to the outside, the corporate assets corresponding to the amount of capital stock, capital surplus and appropriated earned surplus other than the reserve for dividend purposes will be maintained. Further, even if, of income available for dividends, only the amount which exceeds the amount corresponding to necessary working capital is distributed to the outside, working capital will be maintained. Accordingly, retained income, income available for dividends, and disposable income are distinguished because of the difference of capital to be maintained in each case, as well as the difference of point of view, i. e., accounting, legal, and managerial. Therefore, it should be noted that all these concepts are related to the maintenance of capital.