I wish to thank the editors of the Review of Accounting Studies for the opportunity to discuss Jim Ohlson’s paper. I am always informed by his analyses and this paper is no exception. I will attempt to articulate where I see this analysis fitting into a broader literature and to identify what I see as the important lessons. My remarks will discuss the prior history of transitory earnings, major examples of empirical research where transitory earnings is a key issue, how this analysis compares with prior models of Ohlson, key implications of the analysis, and opportunities for future research.

History of Transitory Earnings

The concept of transitory earnings has a rich history in financial statement analysis. In their classic 1934 treatise, Graham and Dodd state in the chapter “Significance of the Earnings Record”:

The concept of earning power has a definite and important place in investment theory. It combines a history of actual earnings, shown over a period of years, with a reasonable expectation that these will be approximated in the future, unless extraordinary conditions supervene. (429, emphasis added)

After highlighting the importance of extraordinary events, they then proceed to describe the variety of ways to extrapolate from past earnings history to expectations about future earnings and to illustrate the importance of removing unusual items from the earnings record that are not likely to be present in future earnings. We can see this philosophy reflected in analysts’ reports that remove special items when displaying the earnings history of a firm.

The Financial Accounting Standards Board (FASB) has long been concerned with the concept of comprehensive income and the proper treatment and display of certain income items, such as gains and losses on investment securities and gains and losses on foreign currency translation. In SFAS No. 130, the FASB states:

Some users of financial statement information expressed concerns about the increasing number of comprehensive income items that bypass the income statement. Currently, an enterprise is required to report the accumulated balance of those items in equity. However, because of the considerable diversity as to how those balances and changes in them are present in financial statement, some of those users urged to Board to implement the concept of comprehensive income . . .
As a first step in implementing the concept of comprehensive income, this Statement requires that all items that meet the definition of components of comprehensive income be reported in a financial statement for the period in which they are recognized.

One can interpret the requirement for an explicit statement reconciling such items as a political solution and a compromise to reporting comprehensive income in the income statement. However, the analysis in this paper provides a rationale for the separate treatment of transitory components of earnings.

My earlier research (Beaver, 1981) also reflects some interest in the nature of transitory earnings.

Events occurring within a particular period may be atypical (transitory) and not expect to have the same impact on earnings in subsequent periods. Accounting earnings can be viewed as two components: permanent earnings and transitory earnings. Permanent accounting earnings can be thought of as the expected value of future accounting earnings. (105)

As stated, this definition is vague and lacks the precision and formality of treatment provided by the Ohlson model. At best, it provides an intuitive notion of transitory earnings, which helps to explain why the relation between earnings changes and price changes is not a simple one-to-one relation.

**Prior Empirical Research**

Transitory earnings also have a long history in empirical accounting research. In Beaver, Lambert, Morse (1980) and Beaver, Lambert, Ryan (1987), we attempted to make the concept of transitory earnings more explicit by positing that earnings follow an IMA (1,1) process plus a garbling item. Here transitory earnings consist of two component, the garbling term and that portion of the current earnings shock that does not affect future expected earnings. Neither of these components is priced in the valuation equation. In retrospect, this approach is somewhat ad hoc, and the Ohlson analysis offers considerable improvement and generalizability of the concept.

Other empirical research specified different stochastic processes for earnings, where a portion of the earnings could be characterized as “transitory.” This includes Collins and Kothari (1989), Collins, Maydew, and Weiss (1997), and Collins, Pincus, and Xie (1999). Collins and Kothari identify the persistence of earnings as one of the determinants of the earnings response coefficients. Collins, Maydew, and Weiss regress the annual slope coefficient for earnings in a valuation equation on several variables, including ONE, the absolute value of one-time items as a percentage of core net income and find a significant negative relation. Collins, Pincus, and Xie examine the slope coefficient for positive and negative net income firms and find that the slope coefficient for negative net income firms is not significantly different from zero. This evidence is consistent with the capital markets placing a lower (in the limit, zero) coefficient on transitory components of earnings.

In many studies, an assumption is made about the transitory nature of certain income statement components. For example, Dechow, Hutton, and Sloan (1999) and Frankel and