

1999/2000 Edition

*Core Concepts of
Accounting Information*

Accounting
Issues
Involving
Income and
Cash Flows

Karen V. Pincus

*Core Concepts of
Accounting Information*

Theme II

Accounting Issues Involving Income and Cash Flows

1999/2000 Edition

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University of Arkansas



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Core Concepts of Accounting Information
Theme II: Accounting Issues Involving Income and Cash Flows

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Core Concepts of Accounting Information
Theme II: Accounting Issues Involving Income and Cash Flows

FEEDBACK ON COURSE MATERIALS

Comments, corrections, and suggestions for future topics and assignments are greatly appreciated. Address any feedback to:

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Core Concepts of Accounting Information
Theme II: Accounting Issues Involving Income and Cash Flows

ORGANIZATION OF COURSE MATERIALS

Core Concepts of Accounting Information is organized into 4 broad themes:

- Theme I:** *The Users/Uses of Accounting Information*
- Theme II:** *Accounting Issues Involving Income and Cash Flows*
- Theme III:** *Accounting Issues Involving Economic Resources*
- Theme IV:** *Accounting Issues Involving Capital*

Each theme looks at a variety of topics that cut across the major functional areas of accounting--financial accounting, managerial accounting, systems, tax and auditing. Examples from business, non-profit and government organizations--both domestic and international--are used throughout the themes. Each theme is further divided into modules that follow the same organizational pattern across the themes:

- ◆ The first module of each theme provides an introduction to the theme, describing the key points to be covered and presenting needed terminology.
- ◆ The remaining modules explore the topics of the theme from the perspective of a particular user group for accounting information: management, owners and creditors, government and other users.
- ◆ Theme I also contains a final module on the environment of accounting that introduces the body of technical rules, laws, standards and guidelines in the 5 major functional areas of accounting and discusses how to research accounting questions and problems.

Pagination

Core Concepts of Accounting Information is divided into themes and modules, which different schools put together in a variety of ways.

How do you find material within your bound text? After this preface, pagination is of the form I-2-3, where the initial roman numeral indicates the theme, the middle number indicates the module within the theme, and the final number indicates the page within the module. Thus, page I-2-3 indicates Theme I, Module 2, page 3.

CORE CONCEPTS OF ACCOUNTING INFORMATION

**THEME II: Accounting Issues Involving Income and
Cash Flows**

Karen V. Pincus

Theme Contents

Acknowledgments	vi
Feedback on Course Materials	vii
A Few Words About Copyrights, The Pricing of Course Materials and Photocopying	vii
Organization of Course Materials	viii
MODULE 1: INTRODUCTION	Tab 1
MODULE 2: OWNERS' AND CREDITORS' USES OF INCOME AND CASH FLOWS INFORMATION	Tab 2
MODULE 3: MANAGEMENT USES OF INCOME AND CASH FLOWS INFORMATION	Tab 3
MODULE 4: GOVERNMENT AND OTHER USERS OF INCOME AND CASH FLOWS INFORMATION	Tab 4
Index	Tab 5

Note: Detailed tables of contents for each module appear at the front of the modules.

MODULE 1: INTRODUCTION

1999-2000 edition

Table of Contents

Estimated Time Budget	II-1-1
CONCEPTS OF INCOME	II-1-1
Economic Definitions of Income	II-1-3
Accounting Definitions of Income	II-1-4
Problems With The Unit of Measure	II-1-4
Problems With Making Periodic Measurements of an Ongoing Process	II-1-5
Example 1: An Easy (But Uncommon) Case	II-1-6
Example 2: A Harder (But Common) Case	II-1-6
The Results of These Problems	II-1-7
SOME TERMINOLOGY	II-1-7
Accounting Terms Used For Business Enterprises	II-1-8
Accounting Terms Used For Non-Business Enterprises	II-1-8
Accounting Terms Used To Describe Costs	II-1-8
Accounting Terms Used To Define Taxable Income	II-1-9
INCOME VERSUS CASH FLOWS	II-1-18
The Relationship Between Income and Cash Flows	II-1-18
The Income Statement	II-1-21
The Statement of Activities	II-1-24
The Statement of Cash Flows	II-1-24
Financial Statement Articulation	II-1-30
Income Versus Cash Flows: A Numerical Illustration	II-1-30
Sales Revenue versus Cash Receipts from Sales	II-1-32
Insurance Expense versus Cash Payments for Insurance	II-1-32
SPECIAL GROUP ASSIGNMENT FOR THEME II	II-1-35
ASSIGNMENTS FOR MODULE 1	II-1-38
ASSIGNMENT II-1-1: <u>The Relationship Between Income and</u>	
<u>Cash Flows</u>: Reading Financial Statements	II-1-38

ASSIGNMENT II-1-2: <u>The Relationship Between Income and</u> <u>Cash Flows: Reading Financial Statements #2</u>	II-1-41
ASSIGNMENT II-1-3: <u>The Statement of Cash Flows: Operating, Financing and</u> <u>Investing Activities</u>	II-1-43
ASSIGNMENT II-1-4: <u>Income Versus Cash Flows: Bally</u> <u>Manufacturing Corporation, 1989</u>	II-1-45
ASSIGNMENT II-1-5: <u>Income Versus Cash Flows: Preparing</u> <u>Income and Cash Flows Statements #1</u>	II-1-76
ASSIGNMENT II-1-6: <u>Income Versus Cash Flows: Direct Versus</u> <u>Indirect Method Cash Flows Statements #1</u>	II-1-78
ASSIGNMENT II-1-7: <u>Income Versus Cash Flows: Preparing</u> <u>Income and Cash Flows Statements #2</u>	II-1-79
ASSIGNMENT II-1-8: <u>Income Versus Cash Flows: Direct Versus</u> <u>Indirect Method Cash Flows Statements #2</u>	II-1-80
ASSIGNMENT II-1-9: <u>Income Versus Cash Flows: Preparing</u> <u>Income and Cash Flows Statements #3</u>	II-1-81
ASSIGNMENT II-1-10: <u>Income Versus Cash Flows: The Topps</u> <u>Company, Inc., 1993</u>	II-1-83
ASSIGNMENT II-1-11: <u>Income Versus Cash Flows: The Boston</u> <u>Celtics</u>	II-1-85
ASSIGNMENT II-1-12: <u>The Relationship Between Income and</u> <u>Cash Flows: Accrual Basis vs. Cash Basis</u>	II-1-88
ASSIGNMENT II-1-13: <u>Financial Statement Articulation: Finding</u> <u>the Missing Links</u>	II-1-90
ASSIGNMENT II-1-14: <u>Financial Statement Articulation: Finding</u> <u>the Missing Links #2</u>	II-1-93
 SOLUTIONS FOR THE SELF-CORRECTED ASSIGNMENTS	II-1-96
SOLUTION TO ASSIGNMENT II-1-1	II-1-97
 MODULE INDEX	II-1-99

MODULE 1: INTRODUCTION

CONCEPTS OF INCOME

Wealth: Any income that is at least one hundred dollars more a year than the income of one's wife's sister's husband.

--H. L. Mencken

The primary purpose of every business enterprise is to earn a profit, or net income, for its owners. Maximizing the profits of the business serves the interest of the owners. Failure to achieve expected profits is a cause for much consternation. Consider, for example, the following September 10, 1990 *Wall Street Journal* report by Jim Carlton about a \$27.4 million dollar loss reported by Oracle Systems Corp. (now renamed Oracle Corp.), a software company:

Oracle said it would report 30% revenue growth for its fiscal first quarter ended Aug. 31, but added that "unfortunately" the Redwood City, Calif., company had built up its operations in expectation of 50% growth. As a result, expenses outpaced revenues, causing a quarterly loss of about 20 cents a share, the first in the computer software company's 13-year history....

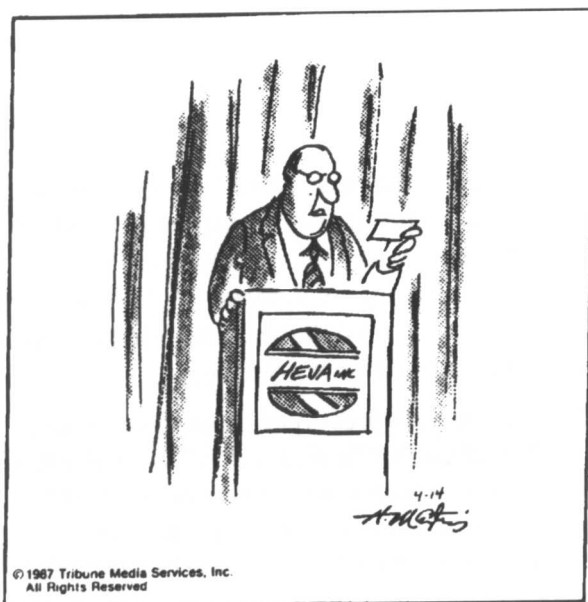
Following Oracle's disclosure of its woes late Thursday, the company's stock slipped Friday in national over-the-counter trading, dropping \$1.75 a share to close at \$8.125 a share, with nearly 10 million shares changing hands....In a move that analysts said was tied to the quarterly loss, Oracle last week replaced Gary D. Kennedy as head of its Oracle USA unit...

For the next two years, Oracle struggled to recover from its troubles. Oracle reported a \$12.4 million loss for 1991, but managed to turn things around to report a positive net income in 1992 and 1993. By 1995, a fully recovered Oracle was able to report record-setting revenues and strong earnings.

Even non-profit organizations—which pursue social goals, rather than profit maximization, as their primary purpose—seek to operate at break-even or better, and generally prefer operating at a surplus (a profit) rather than a deficit (a loss). Additionally, no matter how noble the organization's social goals, a non-profit organization cannot ignore its cash flow needs. Non-profit organizations, like businesses, can become over-extended.

Consider the case of the Sacramento Symphony, which began its corporate life in California's state capitol in 1948. For decades, the symphony grew and thrived. By

the mid-1970s, 88 musicians were playing a 36-week annual schedule of concerts. Ticket sales brought in most of the symphony's revenue, with some donations as well. From 1982 to 1985, the symphony did particularly well, with revenue exceeding expenses by about \$100,000 each year, which added to the symphony's endowment fund. However, as the musicians pressed for higher salaries and more concert dates, ticket sales did not keep pace. Starting in 1986, the symphony began operating at a deficit, with expenses exceeding revenue by \$300,000 to \$500,000 per year.



"This years annual report is brief. The bottom line is \$1.98. Any questions?"

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In 1992, with funds running out and debt mounting, the symphony began a long struggle to cut costs and increase revenue. A new director hired from the Buffalo Philharmonic cut management salaries, got the musicians to agree to a two-year pay freeze, and led a drive to raise pledges of \$1 million from the community, contingent on balancing the organization's budget. But the musicians refused to agree to the 25% pay cut necessary to balance the budget (their salaries accounted for just under half the budget, which is a bit better than the 52% industry average). By September 1996, the symphony owed over \$1,000,000 to creditors and subscribers. Banks began to call in their loans for nonpayment and musicians began to leave for other jobs. Early in 1997, the city of Sacramento seized the organization's office furniture, instruments, and music library to help pay creditors. The symphony had to shut its doors for good.

Nor are governments immune from a focus on the "bottom line," although, as a non-business organization, they generally strive to break even or operate at a small surplus, rather than to maximize profits. Consider what can happen when a government entity's expenditures far outstrip its revenues. In 1995, the government of

the District of Columbia was on the verge of bankruptcy with a \$722 million annual deficit in a city of 600,000 people. To avert bankruptcy of the nation's capital, President Clinton signed a bill authorizing the city to borrow hundreds of millions of dollars from the federal government. In return, the bill also required the city to balance its budget within three years and answer to an oversight board with broad powers over the mayor and city council. By 1999, the city had a \$200 million budget surplus.

Since there is such widespread agreement that a positive "net income" (or operating "surplus" or "increase in net assets" for a non-profit or government entity) is desirable, it may surprise you to learn that the meaning and measurement of "income" are topics of long and continuing debate in accounting.

What is income? In the sections below, we discuss how income is defined by economists and by accountants. You will see that their definitions are related, but by no means identical. Then, we'll examine some of the difficulties involved in measuring income. By learning about the limitations of income measurement, you'll begin to understand why accounting measures of income may vary depending on the purpose of the measurement—for example, an organization's income for financial reporting purposes and tax purposes may be two different numbers.

Then, we'll consider the difference between income and cash flows. You'll begin to think about why organizations need information systems that produce a variety of income and cashflow measures. You'll see how accrual-basis measures differ from cash-basis measures. Finally, some terminology you will need to discuss accounting issues involving income and cash flows will be defined.

Economic Definitions of Income

Adam Smith, an economist who lived at the time of the American Revolution, offered one of the first economic definitions of income. Smith defined "income" as the amount that could be consumed (used up) during a period without diminishing the productive resources—like factories, machines and other productive inputs—which economists term "capital." [Note that the word "capital" has several different meanings when it is used in economics, finance and accounting.]

Centuries later, J. R. Hicks followed Smith's line of thought and provided one of the classic economic definitions of income: income is the amount that a person can consume over a period of time while still being as "well off" at the end of the period as at the beginning. From this point of view, wealth is what you have at an instant of time; income is what you can consume during a period and still maintain that initial wealth. Thus, for any particular period, your income is equal to what you have consumed (used up) during the period plus any change in your wealth from the start to the end of the period.

Much of economics is purely theoretical—or, as renowned economist John Kenneth Galbraith once sarcastically described it, "abstract speculation unmarred by social purpose." The economist's definition of income is theoretical, an abstraction that doesn't contemplate actual measurement. "Well-offness" and "income" are important concepts, but well-offness is constantly changing, making income difficult to measure.

Accounting Definitions of Income

Accountants, on the other hand, deal in the practical realities of measurement. So it should not surprise you that the accountant's definition of net income is stated as a measurement rule. To an accountant, **net income** is defined as the difference which results from adding all the organization's revenues and gains for a period and subtracting all its expenses and losses for the period.

Why does the accountants' definition of income differ from the economists' definition? Users of accounting information want a measure of income to aid them in tasks such as making pricing decisions, assessing management's past performance, predicting the organization's future performance, and assessing the organization's fair share of taxes. While the conceptual definitions of income and wealth may be elegant, measuring the periodic change in a person's or organization's "well-offness" is considerably more messy. Two of the major causes of this messiness are:

- ◆ problems with the unit of measure, and
- ◆ problems with trying to make periodic measurements of an ongoing process.

Problems With The Unit of Measure. To start with, accountants have to choose a unit of measure. Long ago, accountants chose money as the basic unit of measure for income. While money is clearly associated with an individual's economic well-being, money is not a perfect measurement unit.

For one thing, money's value changes over time, which is a less than ideal characteristic for a measurement unit. For example, let's suppose your father, who graduated from college 25 years ago, was then six feet tall and earned a starting salary of \$10,000 for his first job. Now, 25 years later, when you are about to graduate from college, you are also six feet tall and will earn a starting salary of \$10,000.

The unit of measurement for height—the foot—is stable over time. So, even though more than two decades have passed between graduations, it's easy to compare your graduation day height to your father's graduation day height. But the unit of measure for income—the dollar in our example— isn't stable. The purchasing power of a dollar today is very different than 25 years ago. The \$10,000 you will earn is not equivalent in purchasing power to the \$10,000 your father earned—\$10,000 was a "lot more money" in your father's day than it is in yours.



"Just for once can't we order dinner without you telling me what each entree would have cost in 1962?"

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There's also another problem with using money as a measurement unit: the change in well-offness when your cash increases from \$1 to \$101 isn't quite the same as the change in well-offness when your cash increases from \$1,000,000 to \$1,000,100, yet the change is \$100 in each case. While your well-offness continues to increase with each increase in cash, the two increases aren't necessarily directly proportional.

The point is not that money isn't a good measurement unit for income or wealth. No measurement unit for "well-offness" is perfect. Despite its problems, money is a very practical choice for a measurement unit. But because there are problems with the measurement unit, income measured in money can, at best, only be an indicator of the economist's notion of income. It is not an exact measure of the concept.

Problems With Making Periodic Measurements of an Ongoing Process. Now think about another thing that makes income measurement messy: accountants are trying to measure periodic income for an organization in the midst of its operations. Trying to measure income for a brief period in a dynamic organization's life necessitates dealing with uncertainty because the income-producing activities are still on-going. A pair of examples might help to clarify this problem.

Example 1: An Easy (But Uncommon) Case. Let's suppose we were back in the days before the Industrial Revolution when many businesses were conducted as "ventures." In a venture, a group of people pooled their cash to finance a particular activity, such as transporting a shipload of tea from one country to another. The venture had a limited life; it lasted only long enough to fulfill its purpose, then it was disbanded. The non-cash assets of the business were all sold, the remaining liabilities were paid, and the leftover cash was split up among the owners according to their proportionate share of the original cash investments.

It isn't very difficult to measure the income of a completed venture. The income is merely the difference between the cash the owners end up with and the cash they started with. Moreover, the short period of the venture means that there isn't much cause for concern about the stability of the measurement unit. So, measuring income for a venture was pretty straightforward.

Example 2: A Harder (But Common) Case. Now think about the problems that arise when accountants must measure the periodic income of an ongoing organization, rather than the lifetime income of an entity that has ceased to operate. In an ongoing organization, many activities are somewhere in the middle of their cash-to-cash cycle when the accounting period ends.

For example, think about an organization that allows customers to buy products (or services) on credit. At the end of the accounting period, there are bound to be some credit sales where the customer has already received goods (or services), but has not yet paid for them. Does the selling organization have any income from these transactions?

The answer depends on the degree of risk that the customers will fail to pay what they owe. If there is no chance of collecting from the customers, there's clearly no income—the organization's not at all better off for having made these sales. On the other hand, if collection is certain, there would clearly be income that could be measured as the full amount of the sales price, less the related costs. But for most organizations that make credit sales, the reality falls somewhere between these two extremes—the majority of customers will pay what they owe, but some portion of the customers will fail to pay. In these cases, accountants must estimate the amount of "**bad debts**" (uncollectible accounts) the organization will face in the future and deduct the estimated "**bad debt expense**" from the full sales amount when computing the current period's net income.



Drawing by P. Sheen. Reprinted by permission.

In computing net income, there are many situations that require the use of estimates. Thus, the calculated periodic net income for a **going concern** (an ongoing organization) is not as to-the-penny-exact a measure as the calculated lifetime income of a venture that has ceased to operate. So, once again, the accountant's measure of net income can be, at best, only an indicator of the economist's concept of income.

The Results of These Problems. Once you recognize that all measures of periodic income have disadvantages, it's easier to understand how there can be legitimate differences of opinion about the best way to measure income. And it can be easier to understand why different users, who have different information needs, may demand different accounting measures of income. This is why the income (or profit/loss) numbers used for financial reporting to external users, for internal reporting to management, and for reporting to taxing authorities may all be different from one another—and why none of the numbers are quite the same thing as the economist's definition of income.

SOME TERMINOLOGY

A word must become a friend or you will not understand it.
—Sir Edwin Coke, 1592

While we're talking about how accountants define and measure income, it's a good time to stop and review some of the other accounting terminology you need to understand when talking about accounting issues involving income and cash flows. Many of the terms you need to know are already familiar to you from your previous

study; but some others may be new. The accounting terms you need to know involve:

- ◆ business enterprises
- ◆ non-business enterprises
- ◆ cost measurement, and
- ◆ taxable income measurement.

Accounting Terms Used For Business Enterprises

Figure II-1-1 provides definitions of basic concepts in financial accounting that influence the measurement of income. The measures described in this table are the focus of an organization's financial reporting to external users—such as investors and creditors—and are also used internally to help management make operating, financing, and investing decisions. The table includes not only the components of income and cash flows measurement, but also the key terms used to measure financial position. When you review this portion of the table, you'll recognize some of those terms as the components of the famous accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

Accounting Terms Used For Non-Business Enterprises

Figure II-1-2 adds a few definitions that apply exclusively to financial accounting by non-business organizations, including nonprofit (or not-for-profit) organizations, such as a charitable foundation, and government entities. While the primary goal of a business enterprise is to make a profit for its owners, non-business organizations do not have owners—their "equity" belongs not to owners, but to constituents. The primary goal of a non-business organization is social: to fill a social need of the organization's constituents. The counterpart to owners' equity for a business is the non-business organization's net resources (or "net assets") available for future expenditures to serve the organization's social goal. For a particular fund (e.g. the Scholarship Fund of a university), the net assets are termed "fund balance." Thus, the accounting equation for a non-business organization is:

$$\text{Assets} = \text{Liabilities} + \text{Net Assets}$$

or

$$\text{Assets} = \text{Liabilities} + \text{Fund Balance}$$

Accounting Terms Used To Describe Costs

To determine the profitability of their products, services or activities, organizations need detailed information about the costs of their operations. Figure II-1-3 presents