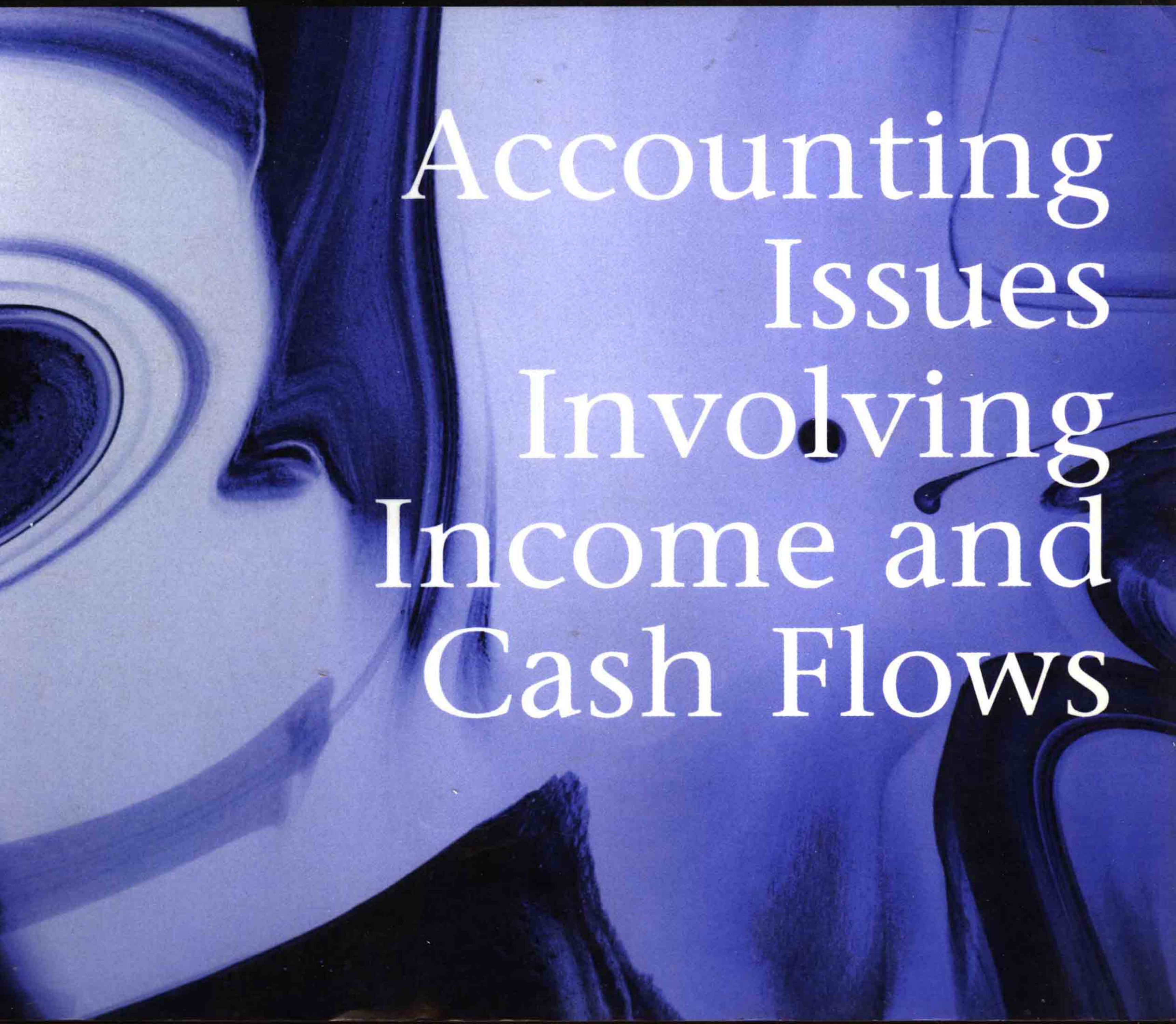
Core Concepts of Accounting Information

Theme II

1998/1999 Edition

Karen V. Pincus

Accounting Issues Involving Income and Cash Flows



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Accounting Issues Involving Income and Cash Flows

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FEEDBACK ON COURSE MATERIALS

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

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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

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

MODULE 1: INTRODUCTION

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Table of Contents

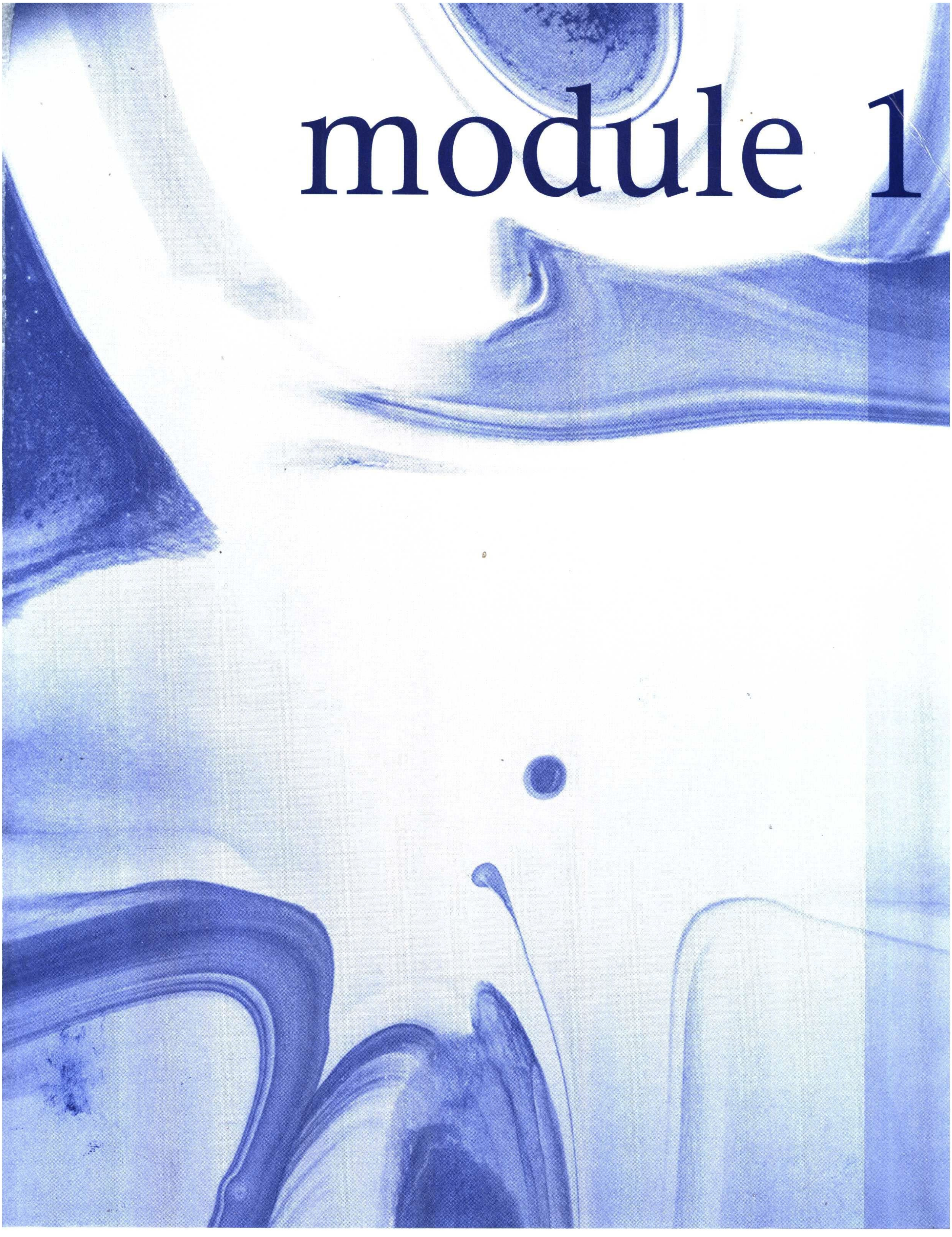
MODULE 1: INTRODUCTION

Estimated Time Budget

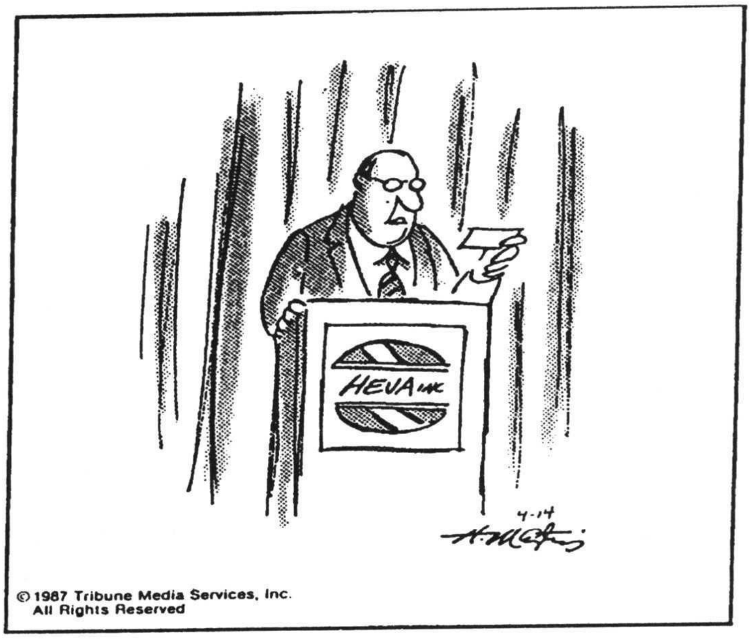
Task	Time Estimate
Reading	60 - 90 minutes
Assignments	
Assignment II-1-1	15 - 20 minutes
Assignment II-1-2	20 - 30 minutes
Assignment II-1-3	10 - 15 minutes
Assignment II-1-4	90 - 120 minutes
Assignment II-1-5	45 - 60 minutes
Assignment II-1-6	45 - 60 minutes
Assignment II-1-7	45 - 60 minutes
Assignment II-1-8	45 - 60 minutes
Assignment II-1-9	45 - 60 minutes
Assignment II-1-10	30 - 45 minutes
Assignment II-1-11	45 - 60 minutes
Assignment II-1-12	60 - 90 minutes
Assignment II-1-13	30 - 60 minutes

Note: *These time estimates, like all the time budgets for this course, should be adjusted to suit your own learning style. Time estimates for assignments assume that readings were completed before attempting the assignments.*

module 1



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 to help out, 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. But 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.

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.