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Whither the Concept of Income?

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On the Evolutionary Advantage of Cost Accounting and Conservatism

- 1 Braun, E. (2016). The Ecological Rationality of Historical Costs and Conservatism. doi: 10.1515/ael-2015-0013.
- 2 Basu, S. & Waymire, G. (2017). Historical Cost and Conservatism Are Joint Adaptations That Help Identify Opportunity Cost. doi: 10.1515/ael-2016-0070.
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- 4 Tang, V. (2017). The Role of Accounting and the Debate between Historical Cost and Fair Value. doi: 10.1515/ael-2016-0066.
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Abstract: Since the 1970s, the decision-usefulness has taken center stage and our attention has been concentrated on valuation of assets and liabilities instead of income measurement. The concept of income, once considered the gravitational center of accounting has lost its primacy and become a byproduct of the balance sheet derived from the measurement of assets and liabilities. However, we have not been equipped with robust conceptual foundation supporting theoretically reasoned accounting measurement. It is not only theoretically but also practically important to renew our seemingly waned interest in the concept of income because ongoing reforms of accounting standards cannot be successfully implemented without a sound understanding of the concept of income.

Keywords: concept of income, revenue-expense view, asset-liability view, neoclassical economics, Hicksian income

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1 Accounting standards and neoclassical economics

For years, the International Accounting Standards Board (IASB)¹ has been promoting accounting standards based on the asset-liability view or balance sheet approach leading to the widespread use of fair value measurement. It declares:²

The definition of income encompasses both revenue and gains.

Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this *Conceptual Framework*.

An item that meets the definition of an element should be recognised in the financial statements if: (a) it is probable that future economic benefits associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability.

Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities.

It advocates accounting standards based on the asset-liability view rather than revenue-expense one because not the latter but the former is consistent with neoclassical economics, on which the standard setter claims to rely. According to a joint staff paper of the IASB and FASB, “the definitions of the elements are consistent with an ‘asset and liability view,’ in which income is a measure of the increase in the net resources of the enterprise during a period, defined primarily in terms of increases in assets and decreases in liabilities. That definition of income is grounded in a theory prevalent in economics”.³

However, not everyone in the accounting community endorses the IASB’s position. Particularly since the financial crisis in the late 2000s, criticism against the IASB has become vocal. Practitioners have been mainly targeting the

1 And, more or less, the Financial Accounting Standards Board (FASB).

2 IASB (2010, 4.29, 4.30, 4.38, 4.47). “By defining performance as the change in net assets...the IASB adopts a balance sheet approach to the determination of income. This means that the recognition of the elements of financial performance follows from the recognition (and measurement) of changes in resources (assets) and claims (liabilities) in the statement of financial position” (van Mourik & Katsuo, 2015, p. 205).

3 Bullen and Crook (2005, p. 7). Although the IASB has not officially endorsed the staff paper, it has never issued any theoretical piece of this kind or statement contradicting the paper.

inflexible application of fair value measurement and a resultant about-face during the crisis, while some academics have raised doubt about the theoretical underpinning of the IASB's approach.

Interestingly, both proponents and opponents of the asset-liability view and fair value measurement as its corollary seem to agree on one key point: neoclassical economics supports the asset-liability view. The two camps differ on how relevant the neoclassical assumption of human rationality and market efficiency is in constructing and codifying accounting standards. The IASB and its supporters seem to believe that the assumption underlying neoclassical economics is robust enough for practical application to accounting measurement based on the asset-liability view, while its critics argue against it due to its limited, if any, relevance to the real world. For example, armed with behavioral economics, Braun (2016) argues that the traditional accounting principles based on the revenue-expense view are ecologically rational in the sense that those who adhere to them have an evolutionary advantage in an uncertain world, while the neoclassical rationality assumption is too out of touch with actual human behavior to be used as a starting point for standard setting.

We agree with those critics in that their non-neoclassical standpoint would enrich our understanding of accounting standard setting and measurement, and the IASB has failed to give us a convincing argument for justifying the current standard setting practice with the neoclassical way of economic thinking. However, we differ on one crucial point from both the IASB and its critics: we argue that neoclassical economics neither support the asset-liability view nor reject the revenue-expense one.

In the following pages, we reconsider the concept of income elaborating our argument as to the subtle relation between accounting and neoclassical economics. As we concentrate on neoclassical economics when discussing economics, “economics” and “economists” mean neoclassical ones hereafter.

A reader well-versed in a theoretical controversy over accounting income may directly go to the fourth section on the economic concept of income, although we believe the second and third sections contribute to a fuller understanding of the relation between accounting and economic income concepts.

2 Comprehensive income and earnings

As the value of securities which are traded in markets is dependent on the estimated value of the company issuing them, the accounting system linking

investors and companies should strive to offer information useful for more precise estimation as its major objective. At least it seems to be one of the fundamental premises for contemporary accounting standard setters. For other purposes than the value estimation, accounting information may be useful but need be adjusted accordingly. Although such adjustment is easier said than done, we would leave any problem caused by adjustment aside and concentrate on the so-called decision-usefulness of accounting information. Since the corporate stock value is determined by the prospect of future flows, investors naturally focus their attention on such flow information as income.⁴

However, the concept of income, once considered the gravitational center of accounting,⁵ has gradually lost its primacy and become a byproduct of the balance sheet derived from the measurement of stock, i. e., assets and liabilities. This trend was at the peak when the IASB started the Performance Measurement Project (subsequently Financial Statement Presentation Project) at the turn of the century. It proposed that: comprehensive income (CI), the periodic change of net assets from all transactions except shareholder-related ones, be the only legitimate income concept; therefore the use of traditional earnings, which subtract unrealized transactions from CI, be prohibited even if widely accepted as a crucial number in major capital markets for years.

In other words the project sought not to add CI to existing earnings as publicly available information but to replace the latter with the former. It seemed to intend to make accounting information solely depend on easily recognizable stock values of asset and liabilities, and reduce the scope of discretion as much as possible in the measurement of income. At an early stage the IASB had turned a deaf ear to a dissenting view that the expulsion of earnings would decrease rather than enhance the usefulness of accounting information. Later the IASB acquiesced to the continued use of earnings, but tried to belittle earnings in the overall architecture of financial statements through the severe restriction or quasi-denial of OCI recycling.⁶ However, the IASB's position has been substantially changed partly due to some personnel

⁴ It is true that a cash-based flow is not equivalent to an accruals-based one periodically, but the latter, if constructed properly, works as a proxy for permanent income in an economic sense.

⁵ More than half a century ago, Littleton (1953, p. 20) confidently claimed that “idea of income is more fundamental in accounting than idea of capital, assets, or financial statements” in a chapter titled “Center of gravity”. However, it is unlikely that the IASB would come back to this position.

⁶ “Some gains and losses recognised in OCI are reclassified to profit or loss when realised or at a time specified by particular Standards. Such reclassification is sometimes referred to as ‘recycling’” (IASB, 2013, 8.8).

change of the board recently. In the recently published discussion paper on the Conceptual Framework,⁷ earnings, now renamed “profit or loss”,⁸ have been given primary importance for assessing corporate performance, and the necessity of recycling, though not complete but at least partial, has been recognized.

3 Confused “reform” of accounting standards: Asset-liability view and concept of income⁹

Why has the concept of income, dormant for years, come back to the center stage of accounting standard setting? It is true that the proposal of CI has provided direct impetus, but would not have stirred such heated controversy had it been only proposed that CI be added to traditional earnings. Certainly a rather eccentric assertion that the former be the only legitimate concept with complete exclusion of the latter has urged accounting profession to rediscover the importance of income concept long pushed into the background. As mentioned above, because CI is merely the periodic change of net assets from all transactions except shareholder-related ones, it has by definition no additional informational content beyond the one already contained in the balance sheet. If the balance sheet information were sufficient for assessing enterprise or equity value, we would not need to expect any informational role for income figures.

However, as Saito (2009, ch.2) and others incessantly point out, the aggregated net stock value of corporate assets and liabilities would not have stable relations, let alone coincide, with corporate value per se even if assessed at market or fair value, because the value of goodwill, a crucial part of corporate value, is independently determined according to conditions and circumstances specific to each company. For this reason, income is expected to complement the balance sheet information to assess corporate value, although such a simple balancing item as CI is of little practical value. The expulsion of earnings from financial statements would inevitably lower the quality of accounting information.¹⁰

⁷ IASB (2013).

⁸ The IASB's conceptual framework project seems to be still in too early a stage to decide whether this renaming has any substantial meaning.

⁹ See Ohlson et al. (2011) for a constructive proposal for improving revenue (income) recognition different from the current IASB and FASB orthodoxy.

¹⁰ It is quite suggestive that ROE, one of the most talked-about numbers in markets, is routinely calculated with earnings rather than CI as its numerator.

Although the IASB has recently backtracked on its attempt to expel traditional earnings from financial statements, it seems to be a tactical retreat due to fierce outside opposition rather than a theoretical reconsideration.¹¹

At first glance it seems puzzling why the IASB so adamantly stuck to CI as the only permitted concept of income though lacking any theoretical or empirical evidence, and consequently caused much confusion. It is highly unlikely that decision-usefulness for investors, a much vaunted objective of accounting information in the Conceptual Framework, was forgotten only on this occasion. We suspect the IASB must have concentrated on the process of income derivation rather than income itself. As long as we maintain the so-called clean surplus relation linking the balance sheet and income statement under which assets/liabilities and revenue/expenses cannot be independently evaluated, the traditional flow-based income (profit or loss) measurement would necessarily constrain recognition and measurement of assets and liabilities. In order to reverse the process, the IASB should have changed the meaning of income.

Broadly speaking, what the IASB has had in mind is the so-called asset-liability view. There are several types of assertions under the same nomenclature though they are not necessarily inconsistent one another:

- (1) information on fair value of assets and liabilities contributes to corporate valuation;
- (2) the change of value of assets and liabilities is useful for assessing future cash flows; and
- (3) it is more logical to derive revenue and expenses from recognition and measurement of assets and liabilities than vice versa.

As already mentioned, (1) ignores the importance of off-balance goodwill in corporate valuation. (2) is limited in its validity even in the case of financial instruments,¹² while cash flows to be earned from operating assets and liabilities are not directly related to the change of their fair value. However, we admit that (3) is not unreasonable in defining interrelated concepts: the more concrete have primacy over the less concrete or more abstract.

From this point of view, income is primarily derived from recognition of revenue and expenses under the traditional revenue-expense view, and ensuing

¹¹ “The IASB is persuaded by the arguments set out in paragraph 8.20 for retaining a concept that would require profit or loss to be presented as a total or subtotal on the statement(s)” (IASB, 2013, 8.22). The arguments cited are more practical than theoretical or conceptual.

¹² If prices are not serially correlated, we cannot derive any information useful for forecasting from the change of market value. In that case, what we could do is to estimate future retrievability or liquidity at most.

carryovers and deferrals are unavoidably passed on to the balance sheet as assets or liabilities. Under this view purely accounting constructs having little, if any, economic¹³ substance are inevitably mixed with “real” assets and liabilities. Needless to say, it is brought about by topsy-turvy operational procedure of defining the more concrete concepts with the more abstract ones. This “defect” clearly shows the supremacy of the asset-liability view in which more concrete concepts, assets and liabilities, are defined first and then their net change is defined as income, which is nothing but contamination-free comprehensive income.

This seemingly well-knit view actually consists of two distinct assertions. First, income does not arise unless assets and/or liabilities change. In other words, if income arises, net assets always change. This part is a necessary condition for income recognition. Second, if net assets change, income always arises. This part is a sufficient condition for income recognition. Combining these two distinct parts together, the asset-liability view à la IASB asserts that the change of net assets is a necessary and sufficient condition for income recognition, and accordingly CI is the only legitimate income concept. We agree that the necessary part is justifiable at least in the context of accounting measurement. We can argue that revenue or expenses would never arise without the change of assets and/or liabilities as long as we maintain the clean surplus relation.

However, the reasonableness of the necessary part does not guarantee that the change of net assets is sufficient for income recognition if income information should be decision-useful for investors as the IASB claims it to be.¹⁴ As already pointed out, CI does not have any additional information content beyond the one contained in the balance sheet because it is a mere plug-in item derivable from the beginning and ending amounts of net assets.¹⁵ It is not an empirical question but a definitional or logical necessity. We may claim that a logically impermissible metamorphosis of a necessary condition into a necessary and sufficient one of income recognition has led to a longstanding attempt to make CI the only permitted concept of income under the banner of the asset-liability view.

Why did the IASB advocate such an ill-considered argument for global integration and/or convergence of accounting standards for a decade in the

¹³ Here “economic” means “of standard neoclassical economics” as understood by proponents of the asset-liability view.

¹⁴ We do not deny that the necessary part itself is disputable. Our point is that the sufficient part is non sequitur even if the necessary part is true.

¹⁵ To be more precise, we need to exclude the result of shareholder-related transactions.

beginning of this century? Most probably the IASB at first tried to make accounting information dependent on recognition and measurement of assets and liabilities under the assumption that their market or fair value would determine corporate value; then went far into an endeavor to make income information a mere byproduct subject to stock valuation. However, as mentioned above, the combined value of assets minus liabilities may not have a clear link to corporate value due to the existence of off-balance goodwill specific to each company. Nevertheless depicting the asset-liability view in stark contrast to the revenue-expense one as if two views were mutually exclusive, the IASB used to ideologically commit to the former as the only right choice, which had prevented a constructive exchange of opinions and led to considerable confusion on accounting standard setting for years.¹⁶

In order to resolve the confusion, on the one hand, we have to reaffirm that only the necessary part of the asset-liability view is valid in the sense that revenue/expenses cannot be recognized unless assets/liabilities are recognized beforehand because the former process needs the latter. However, recognition of assets/liabilities is not a sufficient condition for that of revenue/expenses because we may impose other conditions on income recognition.

On the other hand, we strive for construction of a different income figure useful for investment decision by adding appropriate conditions to CI, with which the different figure must be reconciled through consistent accounting procedures. What has emerged and been widely accepted in financial markets for years is the earnings concept, which excludes unrealized transactions from CI but these excluded transactions summarized as other comprehensive income (OCI) must be recycled to earnings once realized. To avoid any misunderstanding, we emphasize that transactions are considered “realized” when released from business risks in the sense that expectation for future investment prospects is materialized either favorably or unfavorably, regardless of being converted into cash or not.

Without limiting our focus on earnings, we must reconsider the concept of income to overcome the confused situation concerning the worldwide reform of accounting standards. Fortunately the situation has somewhat improved. The IASB seems to have abandoned its rigid stance and adopted an income concept similar to traditional earnings as a crucial element in the Conceptual Framework by the name of profit or loss. Still the IASB has not offered any theoretical justification for earnings as a legitimate income concept.

¹⁶ A heated debate notwithstanding, the IASB and its critics may have interpreted the same shared view differently when applying it to actual standard setting. Also see van Mourik and Katsuo (2015).

4 Concept of economic income: Windfall and OCI

Now we turn to the concept of economic income. Although economists today do not seem to show much interest in the concept of income, accounting scholars and practitioners often invoke contributions on capital and income by such great economists as Irving Fisher, Friedrich Hayek, John Hicks, Nicholas Kaldor, Erik Lindahl and Gunnar Myrdar to justify their own favorite accounting concepts of income.¹⁷ Regrettably it is often the case that those contributions are grossly misunderstood and used only as a license to push whatever proposals for accounting standards. A typical assertion is as follows: economic income is the maximum amount to be consumed during a period maintaining the beginning amount of wealth at the end of the period; in economic thinking the value of wealth is always determined by current market prices; therefore CI or the periodic change of net assets based on market or fair value corresponds to economic income. As shown below, this line of argument is problematic, to put it mildly.¹⁸

As for the economic concept of income, by far the most cited work is Hicks (1946),¹⁹ according to which “we ought to define a man’s income as the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning.”²⁰ Based on this “central meaning” he introduces a first approximation called Income No. 1: “the maximum amount which can be spent during a period if there is to be an expectation of maintaining intact the capital value of prospective receipts (in money terms).”²¹ Income No. 1 indeed seems to support the aforementioned typical claim as advocates of the asset-liability view believe it to be the case.²²

However, what Hicks regards as income (series) is not the stream of expected receipts but a standard stream which has the same present value of the former: “the calculation of income consists in finding some sort of standard stream of value whose present capitalized value equals the present value of the stream of receipts which is actually in prospect.”²³ According to his expression

¹⁷ See Fukui (2011) and Saito (2013, ch. 5) as well as original contributions included in Parker and Harcourt (1969) for details.

¹⁸ Fukui (2011).

¹⁹ Because this great work is the starting point for contemporary dynamic economic theory, no one can claim that any assertion inconsistent with it is theoretically based on economics.

²⁰ Hicks (1946, p. 172). Hicks used “week” as a basic periodic unit of time.

²¹ Hicks (1946, p. 173).

²² The said IASB and FASB staff members explicitly claim it to be (Bullen & Crook, 2005, p. 7).

²³ Hicks (1946, p. 184).

in an interview in later years, “true income, and consequently profit, is something like (Milton) Friedman’s permanent income”.²⁴

It may be argued that what Hicks has in mind is not corporate income but personal one. This rebuttal cannot survive careful reading: “a person’s income can be regarded as the level of a standard stream whose present value is the same as the present value of his prospective receipts. The same applies to a firm. Its income (or profit) is the level of a standard stream whose present value is the same as the present value of its prospective net receipts.”²⁵

Moreover, those who use Income No.1 for justification of CI rarely, if ever, mention another approximation called Income No.2: “the maximum amount the individual can spend this week, and still expect to be able to spend the same amount in each ensuing week.”²⁶

On the other hand, Bromwich, Macve, and Sunder (2010) explicitly take Hicks’s two economic income concepts into consideration. Attributing CI to Income No.1, and earnings to No.2, they conclude that Hicks endorses neither accounting income concept exclusively. We agree with their attribution and propose to go further: Hicks would endorse the primacy of earnings over CI as an accounting approximation to his central concept of economic income.

Although Income No.1 coincides with Income No.2 under the constant interest (discount) rate assumption, which Hicks often adopts as an expediency to make his argument more easily understood, both two approximations diverge if this restrictive assumption is relaxed. Which should be chosen in that case? Hicks’s answer is unambiguous: “Income No.2 is then a closer approximation to the central concept than Income No.1.”²⁷ Income No.1, the amount making intact the stock value during the period, is only used pedagogically as a first approximation because it is more intuitive and easily understandable than Income No.2. It is quite dangerous to cherry pick Income No.1 for window dressing despite the explicit warning by the master himself.

We should be more alert to what impact on accounting time-varying discount rates have, which have taken center stage in financial theory and practice, as shown by the fact that John Cochrane has recently devoted his presidential address of the American Finance Association to the topic: “Many procedures in accounting, regulation, and capital structure implicitly assume that returns are

²⁴ Klammer (1989, p.173).

²⁵ Hicks (1946, p.196).

²⁶ Hicks (1946, p.174). To avoid unnecessary confusion in the present context, we assume the general price level is constant. Because under this assumption the last approximation, Income No.3, exactly coincides with Income No.2, we will not deal with the former explicitly.

²⁷ Hicks (1946, p.174).

independent over time, and hence that prices only reflect cashflow information”,²⁸ but “Discount rates vary over *time*.”²⁹ Accounting standard setters must keep in mind that “what you do with a mark-to-market number might be quite different in a world driven by discount-rate variation than in a world driven by cashflow variation. The mark-to-market value is no longer a sufficient statistic. A loss of value coincident with a rise in expected return has different implications than a loss of value with a decline in expected return. Decisions need to incorporate more information, not less.”³⁰ Under time-varying discount rates, “the risk-free payoff to a long-run investor is an indexed perpetuity, which pays a constant real coupon in every date and state of nature.”³¹ It means the market value of a risk-free asset fluctuates but its income remains constant. It is obvious that not just Hicks’s Income No. 2 but also Cochrane’s multi-period risk-free income concept are closer to earnings than CI, although those who advocate CI based on the asset-liability view routinely claim economics is on their side.

In any case, we could actually observe these approximations to the central meaning of income in markets if the future were completely forecastable and riskless, that is, expectation at the beginning were always identical with that at the ending of a period. However, as this assumption is grossly violated in the real world, the change of expectation during the period leads to that of capital value, which makes it invalid to equate the observed change with income. Because capital appreciation only reflects the *ex ante* and *ex post* difference of not only the periodic performance but also the changed expectation for future cash flows and discount rates, it should not constitute any income concept whose “practical purpose... is to serve as a guide for prudent conduct.”³² If we consume a portion corresponding to the changed expectation, we cannot maintain the same level of consumption in the future, which are inconsistent with both approximations of Hicks’s. How should we deal with changing expectation?

In this regard Hicks’s approach is widely considered standard: “The income which is relevant to conduct must always exclude windfall gains; if they occur, they have to be thought of as rising income for future weeks (by the interest on them) rather than as entering into any effective sort of income for the current week.”³³ Kaldor is more careful on the *ex ante* and *ex post* distinction “first

28 Cochrane (2011, p. 1088).

29 Cochrane (2011, p. 1047).

30 Cochrane (2011, p. 1088). The point that the mark-to-market value is no longer a sufficient statistic is *not* dependent on the assumption of market efficiency.

31 Cochrane (2014, p. 2). If the general price level is constant as we assume in this paper, there is no difference between nominal and real amounts.

32 Hicks (1946, p. 172).

33 Hicks (1946, p. 179).

elaborated by Myrdal”: income *ex post* should exclude windfalls “which have resulted from changes in expectations (relating future periods) between the beginning and the end”, but include “the element of capital appreciation... which would still have taken place if both the events and the states of mind over the period had been correctly anticipated at the beginning.”³⁴ In a word, the (positive or negative) appreciation of stock value due to the changed expectation for future flows does not constitute income. In terms of accounting, CI minus OCI would approximate to the central meaning of income for both an entity and its shareholders.

Then we must consider whether a windfall should be ever recognized as economic income, and if so when. OCI poses the same problem for accountants in recycling. As mentioned above, economic income is a constant series, the capitalized value of which is set to equal that of the stream of future receipts. Since income is defined as the maximum amount an entity can spend this period, and still expect to spend the same amount in each ensuing period, we cannot but exclude the appreciation of capital value from income. This exclusion remains unchanged even if the going concern changes the composition of assets corresponding to capital (equity). Therefore some may claim that OCI as a windfall element of CI should never be recognized as a proper ingredient of the income concept though it affects the value of capital.

This argument for non-recognition or no recycling may be reasonable from the viewpoint of shareholders whose assets are either non-depreciable or perpetually maintained through reinvestment of realized receipts if depreciable. In a sense, income to be brought about by the changed expectation of future prospects will be deferred indefinitely. However, if each project with its initial investment, either depreciable or non-depreciable, is considered a distinct and finitely-lived endeavor, it is not appropriate to take post-project consumption into account in measuring income; rather in total income should coincide with net cash inflows during the life of the project. Although an appreciated part of the asset value may not be recognized as income but carried over as the change of capital, there is no alternative but to recognize the carried amount as income when the project ends. In other words, the appreciation of assets due to the changed expectation is settled once “mere” expectation is finally realized, whether the results are positive or negative. In terms of accounting, OCI as a windfall is to be recycled to income by the end of the project when assets become off-balance.³⁵

³⁴ Kaldor (1955, pp. 60–61).

³⁵ Some argue against recycling because it is unlikely to enhance the value relevance of income information. To be consistent, they should object to recognition of a gain or loss on disposal of assets in income.

A corporation can be regarded as a portfolio of investment projects, and is expected to exist indefinitely as an entity.³⁶ Therefore corporate income can be constructed in two different fashions. On the one hand, investors should evaluate the going concern value of the corporation, income of which should exclude the element of capital appreciation with no need for recycling. On the other hand, the corporate management is obliged to disclose information on its performance timely, which requires income to reflect results of each project separately with the need for recycling once expectation is realized.³⁷ It would be an awkward situation to say the least, if the management were to assess the corporate value instead of investors and make public the estimate of its own capital.

In an uncertain and incomplete world, each project has its distinct time-varying discount rate, with which its asset or capital value is evaluated. A windfall engendered by the changed expectation for future prospects of cash flows and/or discount rates are to be excluded from income on a project-by-project base, carried over as part of net assets through OCI, and recycled once expectation is realized without anything left at the end of the project. Based on this accounting income information provided by the management, investors could estimate corporate income as an infinite sequence and assess the corporate value.

5 Concept of income: Still relevant and needed for accounting research

In spite of an oft-repeated claim by advocates for CI, the concept of economic income does not endorse CI, which is derived mechanically from market or fair value of assets and liabilities, except when expectation plays no role and discount rates are intertemporally constant. In contrast to CI, the traditional earnings concept, which excludes capital appreciation due to the change of expectation and recognizes it as an element of income through recycling only

³⁶ See Biondi (2005) for the close link between accounting measurement and the nature of the firm.

³⁷ As for funds paying a certain amount indefinitely, it is true that asset appreciation due to the changed expectation for future prospects should be carried over as OCI, but recycling may not be always necessary when an asset is simply substituted for another one. A similar situation arises for a business corporation when it swaps an operating asset for another identical in value and kind.

when expectation is realized either favorably or unfavorably, is much more consistent with economic income under uncertainty with varying discount rates, that is, in the real world.

Until recently the IASB had tried to make CI the only legitimate accounting income with the prohibition of earnings; after the failure of this outright attempt, to take any distinct nature from earnings by banning recycling. This global trend in the recent past has had no theoretical basis in the economic concept of income discussed in economic literature. At the same time we have no alternative guidance for constructing a meaningful accounting concept of income either.

Although we have shown economic income is conceptually closer to the traditional earnings than CI with the help of economic literature, Hicks (1946) in particular, this fact alone is not sufficient to settle an aged-old question on the concept of accounting income. We have made economic income compatible with traditional accounting procedures in which a corporation is considered a portfolio of finitely-lived investment projects and its income series should coincide with its net cash inflows in total. However, in order to construct an operational concept of accounting income, we must make further approximation to unobservable Income No. 2, which itself is an approximation of the central meaning of income. It is almost self-evident that no meaningful income concept corresponds to CI, but earnings in the current form may need substantial conceptual transformation to survive our theoretical scrutiny, which is certainly a central theme for studies on corporate accounting today.

Unfortunately we have not accumulated much knowledge on this topic. The fact that the concept of variable income,³⁸ which was proposed more than 60 years ago, is still considered an indispensable building block for further elaboration has implicitly shown our relative lack of concern in the subject despite its critical importance for accounting studies. Direct impetus for the first extensive studies on the concept of income before and after World War II in the United States was a volatile general price level increasing noise in income

38 Variable income is an operational approximation to economic income from the viewpoint of accounting. Roughly speaking, in order to derive periodic income, different valuation procedures are used for monetary assets in the sense that price changes are considered equivalent to cash flows and non-monetary ones: as for the former, the current value is used for both the beginning and ending balances; as for the latter, the current value is used for the beginning balance, while the ending balance is estimated only with information available at the beginning, which is dissimilar to the actually observable ending value. Therefore the unexpected change of non-monetary assets is either left unrecognized or excluded from income if recognized with being recycled once expectation is realized. See Alexander (1950); Solomons (1961) and Saito (2011, 2013) for details.

measurement. Since the 1970s, the decision-usefulness has taken center stage and our attention has been concentrated on valuation of assets and liabilities instead of income measurement. However, we have not been equipped with robust conceptual foundation supporting theoretically reasoned accounting measurement. It is high time to renew our seemingly waned interest in the concept of income. It is not only theoretically but also practically important because ongoing reforms of accounting standards which pay more attention on flow information including income recognition than ever cannot be successfully implemented without a sound understanding of the concept of income.

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