1984

The FASB Approach to Income Determination: Is It Viable?

Gail B. Wright
University of Richmond

Francis A. Bird
University of Richmond

THE FASB APPROACH TO INCOME DETERMINATION: IS IT VIABLE?

Gail B. Wright
Francis A. Bird

E. Claiborne Robins School of Business
University of Richmond, Virgina

1984-13

THE FASB APPROACH TO INCOME DETERMINATION: IS IT VIABLE?

Gail B. Wright, University of Richmond
Francis A. Bird, University of Richmond

A question which has been debated by the accounting profession for decades is whether there exists a single set of correct rules for use in reporting 'true income' which would enable comparability in reporting for all firms to be achieved. Those who believe a 'true income' figure does exist, advance their position by attempting to reduce choices among alternatives.

Not infrequently the debate centers around the matching principle, i.e., the timing of recognition of an expense. Accounting has its basis in the accrual system. It does not necessarily convey cash inflows and outflows of the current period so much as it seeks to serve as a predictor of future cash flows. Matching expense via systematic and rational allocation to related revenues when they are realized is appropriate and acceptable in the accrual system. Thus the question often arises as to whether management should capitalize a given item with amortization over a specified life or whether management should charge the entire item to income for the current period (immediate recognition). This argument is characterized as the debate over existence of a 'true income' figure on a per year basis.

The thread of this argument is repeated constantly throughout the Statements of Financial Accounting Concepts. It is couched in the phrase "The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components."[4, p. 21] This theme, which first appears in Objectives of Financial Reportings by Business Enterprises, the first concepts statement, is repeated throughout the series. Determination of earnings involves the examination of its two components; revenue and expense. At issue here is the appropriate recognition of expenses which lead to the determination of earnings. In Statements of Financial Concepts No. 2, the Board elaborates on the position it will ultimately take in a discussion of comparability.

> Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises...increases the informational value of comparisons of relative economic opportunities or performance.[5, p. xii]

In explanation of its position, the Board states:

> The difficulty in making financial comparisons among enterprises because of the use of different accounting methods has been accepted for many years as the principal reason

> for the development of accounting standards. Indeed, the only other possible reason for wanting accounting standards would be a belief that there was one right method among the available alternatives, and few people, if any, hold any such belief.[5, p. 45]

It must then be questioned whether comparability for the sake of comparability is not tantamount to developing standards based on the belief that to do so will provide a single correct number which is net income or earnings. William Carter rebukes the notion that such efforts would prove fruitful. He stated:

> The 'true income' hypothesis, however, is not a promising approach to policy choices. Accounting income is not an observable phenomenon--it has no real world referent in an accounting environment characterized by uncertainty. The economic reality that accountants seek to portray is subject to multiple interpretations. This ambiguity, of course, is the source of the choice problem.[2, p. 110]

Carter suggests that the approach taken by the FASB is merely an exercise in expediency, a pure attempt to reduce alternatives without reference to reality and hidden in the guise of achieving comparability.

If we examine the application of this approach to the determination of expense for an accounting period, inevitably we examine what the Accounting Principles Board called "three pervasive expense recognition principles:"[1, pp. 154-161] associating cause and effect, systematic and rational allocation, and immediate recognition. Without identifying them by name, the FASB also identifies the same means of matching expense to revenues for a period. By deliberately pointing out a change in order however, the Board seems to suggest that a systematic and rational determination of expenses for a period is the least desirable approach to recognizing expenses in a given period. The implication is, there-fore, that immediate recognition for expenses not clearly associated with specific revenues is preferable.

William Carter argues against this position. He indicates that, in most cases, deferral (i.e., capitalizing costs incurred to amortize them in later periods by some systematic approach) is preferable. He suggests that users themselves could convert statements reported on the deferral basis easily to a flow-through basis if desired. As such, the deferral method would seem to meet the Board's first criterion for financial reporting, that it "is not an end in itself but is intended to provide information that is useful in making business and economic decisions." [12, p. 110] Carter also suggests that compliance with the flow-through method is easier for the Board to monitor and thus is preferable to them.

Preference for immediate recognition accommodates the Board's emphasis on the asset/liability approach which permeates the Conceptual Framework project. This approach has been criticized frequently in the literature as well as by practitioners. William Shenkir, a former Project Director at the FASB describes the issue this way:

> A second basic issue to be addressed in establishing a conceptual framework is: Should the determination of financial position--that is the measurement of assets and liabilities--determine income? That can be called a balance sheet or asset and liability approach. Or should the measurement of income--that is, the process of matching costs and revenues--determine the balances that are necessarily carried forward in the balance sheet? That can be called an income statement or revenue and expense approach. It is extremely important to recognize that the issue is not whether the balance sheet or income statement is the more important statement. Rather, the issue is whether the process of income determination should be based on a systematic matching of costs and revenues or on a measurement of the change in net assets. [7, p. 173]

Supporting the revenue/expense position is W.B. Coutts. In an early treatise he observed that accounting has traditionally held assets to be an accumulation of "costs deferred for matching against subsequent revenues."[3, p. 36] Contrary to the current position of the FASB, Coutts asserts that assets are not simply tangible productive elements but also the costs incurred to bring them to the point where they are capable of producing revenue. This position is in concert with the historical cost model in contrast to the asset/liability position of the Board which seems to connote some idea of wealth subject matter.

EXHIBIT 1

SUBJECT MATTER	MEASUREMENT
Historical Cost historical exchanges	Nominal Dollars
Current Value wealth	Constant Dollars

The model above indicates via the solid arrow that financial statements present the results of transactions or exchanges at historical cost and measure these transactions in nominal dollars. Although financial statements are supplemented with information in constant dollars, another appropriate way to measure exchanges or completed transactions, such information is additional. Current value, which identifies the wealth of the firm, can be measured in either nominal or constant dollars as well but is not an integral part of the financial statements. Thus, the only acceptable presentation for primary financial statements is to report assets at historical cost measured in nominal dollars.

A basic element of this historical cost model is the matching hierarchy found in Exhibit 2.

EXHIBIT 2

MATCHING HIERARCHY
HISTORICAL COST MODEL

ASSOCIATIVE	1) Cause and Effect	
	2) Systematic and Rational	
	3) Immediate Recognition	EXPEDIENT

As indicated above, historical cost income determination utilizes expense recognition principles which associate a cost which has been used up with revenues in some way, either by cause and effect or by a systematic and rational amortization process. In the historical cost model, immediate recognition is used as an expedient approach to expensing costs in those cases in which no cause and effect relationship can be discerned and systematic allocation to future time periods is not warranted because the cost possesses no future benefit or such benefit is extremely tenuous. Consequently, the historical cost model endorses the systematic method of matching costs against revenues as a better basis for the determination of income than the immediate recognition expedient.

In the latest Exposure Draft for the Conceptual Framework project, Recognition and Measurement in Financial Statements of Business Enterprises, the FASB is attempting to avoid a direct confrontation on the asset/liability v. revenue/expense by avoiding the matching principle by name. In fact, it appears that the Board would prefer to drop the term 'matching' from the language of accounting. If matching is dropped from accounting terminology, ceteris paribus, it will disappear from accounting theory as well. It was probably with this in mind that the Board, in providing "further guidance for recognition of expenses and losses", [6, p. 24] is attempting to refocus the theory of accounting along the lines of the economic concept of wealth. The end result of their efforts is an attempt:

1) to restructure the hierarchy along those lines of emphasis which conform to the asset/liability approach, i.e. in their new order of importance, cause and effect, immediate recognition and finally systematic and rational allocation;
2) to identify the hierarchy as consumption of benefits (rather than matching) which the Board defines as a means "intended to recognize the consumption (using up) of economic benefits and occurrence or discovery of loss of future economic benefits during a period."[6, p. 24]

The realities of real world accounting cannot be so easily contravened. It is extremely doubtful that the corporate world and the accounting profession which serves it will agree to relinquish access to the right to employ alternatives among accounting methods which best meet their needs or reflect the economic realities of their business simply because the FASB renames a basic principle 'consumption of benefits.' The profession needs a return to the position that those methods which rely on an associative approach to the process of income determination are an integral and necessary part of the historical cost model for presentation of financial statements. This is the Matching Principle which associates revenues with the costs incurred to earn them, not a theory of consumption of benefits which emphasizes the identification of assets first (using some ill-defined "wealth" criteria) and determination of income second.

REFERENCES

[1] Accounting Principles Board, APB Statement No. 4, (Accounting Principles Board, 1971).

[2] Carter, William, "A Benefits Approach to Certain Accounting Policy Choices," The Accounting Review, January, 1981.

[3] Coutts, W.B., Accounting Problems in the Oil and Gas Industry, (n.p., Canadian Institute of Chartered Public Accountants, 1963).

[4] Financial Accounting Standards Board, Objective of Financial Reporting by Business Enterprises, (Stamford: Financial Accounting Standards Board, November, 1978).

[5] Financial Accounting Standards Board, Qualitative Characteristics of Accounting Information, (Stamford: Financial Accounting Standards Board, May, 1980).

[6] Financial Accounting Standards Board, "Recognition and Measurement in Financial Statements of Business Enterprises," Exposure Draft, (Stamford: Financial Accounting Standards Board December 30, 1983).

[7] Shenkir, William G., "Current Efforts to Develop a Conceptual Framework for Financial Accounting and Reporting," The Academy of Accounting Historians Working Paper Series Volume II, edited by Edward N. Coffman (n.p., The academy of Accounting Historians, 1979).