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The Economic Income Concept in Accounting Thought in the Sixties

Dr. Sultan Al-Sultan

Assistant Professor of Accounting,
College of Administrative Sciences,
King Saud Univ., Riyadh, Saudi Arabia.

Over the years, the concept of income has been constantly discussed by both accountants and economists but without close agreement. In this paper the Alexander definition was used. The purpose of this paper is to examine, only at the theoretical level, whether an economic income concept, as defined by Alexander, might be adopted by accountants to be an adequate measurement of business income concept.

The concept of income has been constantly discussed by both accountants and economists. Yet no close agreement has even been reached. Accountants have traditionally measured and analysed income from the point of view of the business entity, whereas economists have usually examined it, in its micro-economic sense, from the point of view of the individual.

To Fisher[10], economic income is actual personal consumption. He described it as the psychic enjoyments that come from consuming goods and services. He did not recognize increases in personal capital (savings) as income because no current psychic enjoyment could be derived.

Later economists, such as Lindahl[14], Simons[17], and Hicks[12], identified personal economic income as the consumption plus saving. Hicks (p.77), for example, defined income as the maximum amount a man can consume during a period, and still remain as well off at the end of the period as at the beginning. A few economists, such as

Canning[3], Edwards [9], Edwards and Bell[8], Solomons[19], Chambers[4], and Sterling [21], have provided useful interdisciplinary studies.

According to Fisher, an entity, not being a human being, cannot have income. However, Alexander[1], in contrast to the views of Fisher, has adapted the economist's concept of personal income, as defined by Hicks, to the business entity. He defined a year's income by writing (p.127):

> A year's income is ... the amount of wealth that a person, real or corporate, can dispose of over the course of the year and remain as well off at the end of the year as at the beginning.

'Well-offness', according to Alexander, was defined entirely in terms of cash flows discounted at subjective rates of interest. For the purpose of this paper the definition of income presented by Hicks and adapted by Alexander will be used as the fundamental basis for the discussion. The purpose of this paper is to examine, only at the theoretical level, whether an economic income concept, as adapted by Alexander, might be adpted by accountants to be an adequate measurement of business income.

The paper, after brief review of the economic literature for determination of income as above, will begin by setting up two criteria for judgment of the economic concept of income. The evaluation of the two criteria will be examined, and the limitations of the economic concept will be reviewed.

Criteria for Income Measurement

Criteria for accounting measures are standards by which a particular method of measurement can be judged as to practicability, given the goals for the accounting process. Different criteria for different purposes have been suggested. Chambers[5], (p.78), for example, adopts a relevance or usefulness criteria. More specifically, accounting data must be useful or relevant to the adaptive choices necessary in the future action in markets.

A measurement requires that the emphasis must be on defining the attribute to be measured rather than the object(s). For the purpose of this paper two criteria will be examined to judge whether the economic income concept of measurement is practical for the purpose of prediction of future distributable cash flows.

Objectivity

Objectivity of accounting measurements is usually regarded as an important criterion for choosing among measurement methods. A high degree of verifiable evidence, the ability to determine the true facts, is necessary as support for financial statement representations because accountants must always be in a position to assure their readers that financial statements are presenting useful information arrived at in a fair (objective) or reasonable manner.

Despite the common agreement that objectivity is important as a criterion for selecting accounting measurement methods, it is seldom defined. Ijiri[13], (p.134) states:

> Objectivity refers to external reality independent of the persons who perceive it. Therefore, rather than basing the definition of objectivity on the existence of objective factors that are independent of persons who perceive them, it is far more realistic to define objectivity simply as the consensus among a given group of observers or measurers.

To be objective, therefore, attempts to remove the biases of individuals and to reach consensus. This consensus should be based on what a reasonable man would conclude based on the evidence.

Relevance

Financial statements are, generally, used to provide information for predictions of future earnings and solvency for outsiders, while internal reports – generally considered a function of managerial accounting – provide data on which to base plans and by which to evaluate and reward managers. Accountants, therefore, should attempt to develop measurements which will produce accounting information that will give good predictions for the decision makers.

Clearly all users of accounting information do not use identical information, therefore, accountants may not report all information that might be relevant. In order to present the most relevant data, accountants must assign priorities to the legitimacy and importance of those who desire information. The desirability for relevancy causes the full potential of the information at their disposal. The best the accountant can do, therefore, is attempt to minimize the difference between the unknown true measure and its estimate.

Evaluating the Objectivity of Economic Income

Historical costs have been advocated as a basis for evaluation because the original cost can be objectively measured. This means that accounting measurements are free from bias and subjective evaluation – the figures would be similar if different individuals made the same evaluation. However, if the objective is to predict the distributable cash flows, then it is easy to say that traditional accounting income does not meet that objective because investors are not interested in the firm's past profit performance, rather it is the prospects for future profitability that induces investment.

Since the objective is the predictability of distributable cash flows, then the appropriate measures for this would be the economic income. However, it is recognized that economic income is subjective and very difficult to measure. Professors Edwards and Bell in arguing for the conceptual superiority of their own concepts of business and realization profits, reject economic income as the ideal for accounting measurement on practical grounds. They state:

i) it cannot be measured objectively, and
ii) even its subjective measurement normally cannot be accomplished until the firm's plan of operation has been revised (p.43).

However, as advocated by Alexander (p.175), the non-objective character of economic income under conditions of uncertainty is not alone sufficient basis for its rejection in favour of some more objective standards. Actually, uncertainty is not the main factor inhibiting implementation of an ideal theory. Estimates could be made. Even under conditions of uncertainty, however, expected future net receipts are the most important determinants of the value of an asset, and so the most appropriate basis for the determination of income.

Evaluating the Relevance of Economic Income

Accounting income is based on realization rather than expectations. Therefore, accounting income neglects to recognize changes in net tangible assets and changes in goodwill which are not realized in the period. From the economist's point of view, however, changes in tangible assets and goodwill should be counted in income. Since economic income embodies changes in the service potential of assets, economic income is relatively a lead indicator for future distributable cash flows (Alexander, p.174).

Several articles have been written criticizing the indirect measurement hypotheses and the use of current replacement cost accounting. These articles advocated the use of economic income instead of using replacement cost as a surrogate for economic income – Among those: Professor Staubus[20] states:

> An alternative measure that is even more closely related to likely future events is discounted value of future cash flows that have been contractually determined with respect to time and amount [p.651].
> Replacement cost would be distinctly inferior evidence of future cash flows, it should be utilized only in the absence of acceptable evidence of actual or available future cash flow [p.653].

Professors Dickens and Blackburn[7] state:

> The failure of replacement cost as a measure of economic value of specific,... coupled with the impossibility of objective measurement of replacement cost, effectively condemn any concept of income proposed to date that would include holding gains or losses on fixed assets [p.324].

Professor Snavely[18] states:

> The relevant asset figure for balance sheet purposes in the real value of that asset to the owner. Neither historical cost nor current replacement cost is directly relevant (where real values are defined as present values) [p.346].

Since the primary purpose of a financial statement is to present information for prediction of future earnings, then it can be said that the economic income concept is more relevant than historical cost because the historical cost accounting income concept does not depend on future receipts but only on past and current sales. Since economic income depends on expectations and judgements of future receipts, the resulting valuation, and hence business income, cannot be objective but must be

subjective. The choice is between an irrelevant certainty or a relevant uncertainty, that is, the choice is between the income we can calculate precisely but not the income we seek, or the income we seek but we cannot calculate precisely (Hicks, p.82).

Limitations of Economic Income Concept

Economic income is a useful measurement for providing information about the future. This information is relevant for decision makers because they are interested in knowing as much as possible about what will happen in the future. The resulting valuation and hence business income, of course, cannot be objectively measured. The economic income concept contains certain fundamental assumptions, which are open to criticism, mainly from the point of view of practicality (Shwayder, p.34).

First, the economic income concept is designed primarily to fit the case where the future is known with certainty. Unfortunately, no such perfect certainty exists, and therefore future net receipts are uncertain. This, is turn, causes economic income to be uncertain.

Second, economic income discounts expected cash flows by the subjective interest rates which may vary according to the relevant investment, as well as over time. Such variation lends inevitably to an increase in the subjectiveness of the resultant income.

Third, different realization times of expected cash flows produce different measures of capital and thus of income. Inaccuracies in the forecasting of realization dates will, therefore, produce corresponding inaccuracies in the income measure.

Summary and Conclusion

Over the years, the concept of income has been constantly discussed by both accountants and economists but without close agreement. Even among the economists the notion of economic income concept has been defined differently. To Fisher, the economic income is actual personal consumption whereas to Hicks, *et al.*, it is consumption plus saving. In this paper the Alexander definition was used. He defined a year's income as the amount of wealth that a person, real or corporate, can dispose of over the course of the year and remain as well off at the end of the year as at the beginning. It was the purpose of this paper to examine, only at the theoretical level, whether an economic income concept, as defined by Alexander, might be adopted by accountants to be an adequate measurement of business income concept.

Two criteria, objectivity and relevance, were discussed to evaluate the usefulness of the economic income concept for prediction of distributable cash flows. The general conclusion that might be suggested(of course, research is needed to confirm the conclusion), is that objectivity of historical cost may be accepted but it does not measure what we want to measure. On the other hand, relevancy of economic income is being accepted. Objectivity without relevance is not much of a virtue. Therefore, the economic income concept is being the ideal theoretical concept for use in accounting, and only practical measurement problems appear to prevent it from being adopted. However, measurement problems should not be the reason for rejecting the conceptual merit of economic income.

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المفهوم الاقتصادي للدخل في الفكر المحاسبي خلال الستينات

الدكتور سلطان السلطان

استاذ مساعد بقسم المحاسبة ـ كلية الدراسة الادارية ـ
جامعة الملك سعود ـ الرياض ـ المملكة العربية السعودية

لقد نوقش مفهوم الدخل مرارا خلال السنوات بواسطة كل من الاقتصاديين والمحاسبين ولكن دون اتفاق . وقد استخدم في هذا المقال مفهوم الكسندر وذلك بغرض تحديد مدى قابلية هذا التعريف على المستوى النظري للاستخدام بواسطةالمحاسبين كمقياس كاف لمفهوم الدخل للمشروع .