



The Accretion Concept of Income
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THE ACCRETION CONCEPT OF INCOME

G. EDWARD PHILIPS*

ACCOUNTING theory and practice have long suffered from diversity and controversy. There is wide agreement that it must be possible to greatly increase the usefulness of accounting and that the key to achieving this lies in improving accounting theory as a foundation for accounting practice.

This article is an attempt to demonstrate: (1) that progress in accounting theory must begin with income concepts, (2) the appropriateness of a single concept, accretion, rather than a variety of concepts, (3) that the accretion concept is an all-purpose concept, relevant to taxation and other areas as well as accounting, and (4) that general acceptance of this concept would have significant effects on accounting practice as well as "theory."

The accretion concept is neither complex nor difficult but has far reaching implications for accounting theory and practice. The accretion concept defines income as an increase in economic power which can be measured with reasonable objectivity. For an individual, income for a period equals the change in economic power during the period plus the value of goods and services consumed. For other entities, income is the change in economic power adjusted for capital contributions and distributions.

The requirement of objectivity of measurement imposes limitations on the concept, but also is the source of its usefulness. Because the concept does not tell us when a change in economic power is reasonably measurable, it leaves room for disagreement as to whether a wide range of items constitute income. This may appear to be a weakness in the concept but actually is an advantage, since it forces us to focus at-

tion on measurability as the critical question in controversies over income.

In emphasizing objective measurability, the accretion concept differs from the economic concept of income, as usually conceived, and also from the concept implicit in conventional accounting practice. In many discussions of "economic income," present worth of future receipts is stressed as the basis for valuation. The inherent subjectiveness of estimates of future receipts and appropriate discount rates is overcome in the accretion concept by emphasizing market values as value measures. Conventional accounting, rather than being too subjective, sets objectivity standards unreasonably high in insisting on transactions before recognizing many value changes.

Progress in Accounting Theory. The widespread dissatisfaction with the present state of accounting "principles," and also the belief that improvement requires a solid conceptual base, are reflected in the establishment of the Accounting Principles Board and the research program of the American Institute of Certified Public Accountants. The accounting profession urgently needs, and apparently believes in the possibility of obtaining, a basis for determining the soundness of accounting practices.

A critical issue is the question of uniformity versus diversity. Few accountants are willing to advocate achieving uniformity by arbitrarily requiring all firms to follow identical practices. But if comparability is to be attained, the alternative is

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to have each company follow sound practices, with general agreement as to what is "sound." Anyone familiar with the controversies among reputable theorists as to the propriety of such things as variable costing and income tax allocation may conclude that reaching agreement on soundness is a hopeless cause, but the Institute's actions clearly indicate that hope has not yet been given up.

If this hope is justified, then it must be

concepts of income as there are uses of purposes of data related to income. If accounting principles are to be arrived at deductively, we cannot avoid the necessity of starting from some concept of what constitutes income. So long as we accept many concepts of income we will have many theories of accounting. The importance of a single concept of income is discussed in some detail below, under the heading "An All Purpose Concept"



foundation, but is no more than a beginning. The study fails to deal decisively with the most vital question—income concepts. Moonitz correctly points out that the measurement of income involves measuring changes in wealth,³ but admits to “the absence of a theory of valuation or of pricing of assets and liabilities, and

principal problem in the search for a satisfactory measurement of wealth and income. The conflict between “reality” and objectivity is illustrated in the list of five “concepts” of income given below. From the first to the last of the five, objectivity increases at the expense of conceptual reasonableness.

<i>Concepts</i>	<i>Characteristics</i>
Psychic income	Purely subjective. Income is what you think it is—based on “utility” and inseparable from consumption.
Economic present value income	Gains objectivity by omitting “non-economic” factors. Values are dependent on future receipts.
Accretion income	Income is an increase in economic power which can be verified with reasonable objectivity. Relies primarily on market values as measures of economic power.
Accrual accounting income	Mixed. Some use of forecast and market values but generally requires an outside transaction before recognizing value changes.
Cash basis accounting income	Strictly objective. Requires realization in cash.

their related concepts.”⁴ A theory of valuation, however, is essential to a definition of income, and accounting theory can hardly exist without it.

The Accretion Concept. Terminology is important, but not vital, in accounting theory. The argument here is not for the term “accretion” or even “income,” but rather for a concept which is essential as a foundation for accounting principles. The accretion concept is not a revolutionary new concept originating with this paper. Indeed, among the major merits of the concept are its age and the fact that it is consistent with views widely expressed in economic and accounting literature. A revolution is needed, however, in the sense that the accounting profession needs to give recognition to the value of this concept as a normative standard or directional guide in dealing with the problems of financial reporting.

An income concept that is to be useful outside of ivory towers must be measurable with reasonable objectivity. The inevitable conflict between the needs for objectivity and for conceptual soundness is the prin-

Any notion of income must ultimately rest on a concept of subjective well-being or utility and therefore only “psychic” income can claim to represent true income. The distinction between psychic income and economic income is often overlooked, but is of vast importance. When we take the step from psychic to economic income we have already made a large sacrifice of reality for the sake of objectivity. Instead of defining income in terms of satisfactions (psychic income) economic concepts define it in terms of economic power, i.e., command over goods and services which are capable of a money measure.

Although economists have not reached universal agreement on a definition of income, it seems fair to describe economic income as being based on the present value of future receipts.⁵ Thus the theoretically correct way to place a value on an asset

³ *Ibid.*, pp. 15–16.

⁴ *Ibid.*, p. 55.

⁵ Sidney S. Alexander, “Income Measurement in a Dynamic Economy” in *Five Monographs on Business Income*, published by the Study Group on Business Income, American Institute of Certified Public Accountants, 1950, p. 59.

(or on a business as a whole) is to compute the present value of the expected net receipts (dividends) that will be derived from it. Income for a period is equal to the net receipts of the period adjusted for the change in asset values (economic power). This concept of income clearly defines the relevant factors, but any attempts to measure income on this basis must be highly subjective because of uncertainty. We cannot ordinarily predict future receipts and select an appropriate discount rate with much objectivity.

In contrast to this economic concept, the accretion concept bases its measure of economic power on market values, rather than discounted receipts. This can be viewed as a concession of some conceptual soundness in order to gain greater objectivity of measurement. It seems obvious to this writer that the superiority as to objectivity of the accretion concept over economic present value income much more than offsets any loss in conceptual soundness. A more critical question is whether the gain in objectivity of present practice (accrual accounting income) over accretion income justifies the accompanying loss of conceptual soundness.

The principal differences among economic, accretion, and accrual concepts of income relate to realization. Economic present value income has no realization requirement; income arises with an increase in the "true" value of an asset. Accretion recognizes income if the increase in value is reasonably measurable; e.g., reflected in increased market value. This is equivalent to a realization requirement; income is "realized" when objectively measurable market values of assets rise. Present accounting practice has a much stricter realization requirement; generally income is recognized only with an actual market transaction. These differences may be illustrated by considering the income of a corporate shareholder. Economic income

for a given year would be the dividends received adjusted for the change in value of the share, this value measured by computing the present value of expected future dividends. Accretion income would be dividends adjusted for the change in market value. Accrual accounting would ordinarily include only current dividends in income and would recognize the value change when and if the share is actually exchanged. The case for the accretion concept rests on the proposition that market values are sufficiently more objective than computed present values to justify their use despite the loss of conceptual soundness and that the further gain in objectivity does not justify waiting for "realization" as presently defined.

It is perhaps obvious that much objectivity is gained when values are measured by looking to market figures rather than by discounting expected future receipts. It is not so obvious that a serious conceptual loss results from using market values rather than discounted receipts. If everyone in the market made the same forecast of future receipts and applied the same discount rate, market values would equal present values and there would be no difference between accretion income and economic present value income. Market values may be viewed as reflecting various estimates and discount rates. Furthermore, economic power does not exist without market values. For example, an investor may perceive that the present value of future receipts from a given security exceeds market value, but he has no corresponding economic power until the market value rises or the receipts are realized.

The use of the phrase "with reasonable objectivity" in our definition of accretion income might be considered unsatisfactory, since it leaves room for judgment as to what constitutes reasonable objectivity. A principal merit of the concept, however,

is that, while it does not solve all accountants' problems in deciding how to measure income and economic position, it does force a consideration of these problems as being primarily problems of objectivity of measurement rather than of conceptual soundness. This can be illustrated by considering the continuing controversies over inventory valuation, including LIFO and variable costing. Insofar as financial reporting is concerned, these controversies involve "proper" measurement of income. But there are always two aspects to the problem: (a) what is income? and (b) given the necessity for objectivity, how can we best measure it? The second aspect might be phrased differently as: "How greatly must we depart from income as we would like to measure it because of the necessity of being objective in our measurements?" It is neither possible nor desirable to put an end to controversy as to this question. Indeed, the answers can be expected to change with new developments in institutional structures and record keeping techniques. On the other hand, it should be possible to reach wide agreement as to the first aspect. Unless we can agree what it is we are trying to measure, there is little hope that we will agree how to do it.

LIFO, FIFO, and variable costing are all inventory valuation methods based on costs. If our concept of income is that income is a result of matching costs and revenues, then it is proper to discuss the merits of these alternatives in terms of which does the best job of matching. But if our concept of income is in terms of economic power (e.g. accretion income) the question becomes which, if any, of these methods of valuation gives the best balance between objectivity of measurement and portrayal of economic reality.

Under the accretion concept, any change in inventory value (or value of any other asset or liability) which can be measured

with reasonable objectivity would be reflected in the accounts. If this concept is accepted, whether cost or market values should be used is not a question of theory but a question of practicability. Market should be used unless not measurable with sufficient objectivity. If market is rejected, choice of cost method requires a balancing of objectivity with degree of approximation to the "ideal" concept. The argument here is that accretion income should be accepted as the ideal—a normative standard or directional guide to be used in evaluating the merits of alternative practices.

Accrual accounting income is income as measured by present generally accepted practice. This is a mixture of arbitrary rules and concessions to economic reality. It is difficult to see what could fairly be described as an income concept in this practice, but it is common to refer to income as the excess of revenues over costs. In fact, important attempts have been made to demonstrate that the concept of matching costs with revenues is the accounting concept of income.⁶ It appears more appropriate to this writer to view matching not as a concept of income but as a practice which is necessitated (to obtain internal consistency) by our insistence on a rather arbitrary definition of realization. If we did not insist on realization, we would not need to be concerned about matching. It might be maintained that the accretion concept is a realization concept in the sense that a change in economic power is recognized (realized) whenever it is reasonably measurable. But the difference between accretion and accrual accounting with respect to realization is important. In the accretion concept both revenue and expense are recognized when they are reasonably measurable and this alone deter-

⁶ See especially W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards*, American Accounting Association, 1940.

mines the time periods in which they are reflected. There is nothing sacred about transactions.

The accretion concept is of great potential value to accountants as a standard or guide but is not a pat formula or prescription for practice. Those who advocate emphasis on valuation are often accused of failing to see the difficulties of valuing assets or wanting to make accountants into appraisers. Acceptance of the accretion concept implies neither. It does imply recognition of the fact that to the extent that we can measure values objectively we can measure income realistically. Our problem, therefore, is to seek out reasonably objective realistic measures of value rather than to construct a "theory" of income based on matching. The likely effects on accounting practice of general acceptance of the accretion concept are discussed in another section of this article.

Cash basis accounting income carries realization to an extreme. The gain in objectivity is substantial—on a strict cash basis you need not be concerned about depreciation and bad debt estimates—but accountants are agreed the loss in portrayal of economic reality is too great to give useful results in most cases.

Limitations on the Accretion Concept. There are three problem areas in the measurement of income and economic position which are not resolved by the accretion concept. These are (a) defining the entity, (b) adjusting for changes in the value of money, and (c) distinguishing income from "operations" from total income.

The accretion concept assumes that the entity for which income is being measured has been defined. In most instances the entity is quite clear-cut, but serious conceptual problems sometimes arise. For example, it is clear that children often have economic power, but it is not obvious that they, or an individual husband or wife, should be considered an entity separate

from the family. This poses income tax problems, as does the question of whether a corporation is a proper taxable entity apart from its owners. The problems of determining when it is appropriate to consolidate the financial statements of related corporations are familiar to accountants. The accretion concept does not contribute directly to solving these problems. That it would, however, help clarify some aspects of them is illustrated by the fact that accretion would require a parent corporation to include in income any objectively measurable increase of equity in a subsidiary.

Changes in the value of money are ignored in the accretion concept. This departure from "reality" is perhaps largely made up for by the fact that accretion reduces the significance of this problem. Much of our difficulty with price level changes is due to our strict adherence to realization. The effects of gradual changes in price levels on asset values are often realized all at once, with a resulting large distortion of income. To the extent that assets can be revalued periodically, the "bunching" effect is eliminated. This would not make any more "real" an increase in value which corresponds to a rise in the price level, but the distortions caused by delayed realization are eliminated.

The problem of price level changes is related to that of distinguishing operating from non-operating income. Accretion is an all-inclusive concept which makes no distinction between a gain which results from efficient management and one which is a "windfall." It is obvious that such a distinction is useful to many users of financial statements and even that accountants should do their best to provide data that can be used for this purpose, but it does not follow that "operating" income should be the underlying concept of accounting income. Although accountants can often

segregate such unusual value changes as fire losses from other data, the possibility of reasonable objectivity is lost long before all significant "non-operating" events are taken into account. For example, a large rise in inventory values (whether recognized now or later, when realized) might result from astute management planning, non-operating factors, such as unusual market fluctuations, or even poor management if the company was overstocked but hit a fortunate price rise. If we accept the accretion concept and report as income the over-all economic progress of the entity, we can be somewhat more objective than if we attempt to separate out operating income.

An All-Purpose Concept. Proponents of a variety of income concepts, as opposed to a single "all-purpose" concept, emphasize that there are many purposes for which income is measured or that there are many possible approaches to measuring the concept. Although this variety of purpose and possible approach creates complexities, it is not conclusive evidence that a number of concepts must be accepted.

While it is certainly true that different users of accounting data will find different figures relevant to their purposes, it does not follow that there must be many concepts of income. On the contrary, whenever the relevant figure is "income" for a period of time, there is ideally only one figure that is appropriate. A distinction can be made between two tasks of accountants. One of these is the measurement of the economic progress and status of an entity (income and financial position), the other is the collection and interpretation of relevant data for decision making. This distinction is useful even though income and financial position are the relevant data for some decisions. It is often appropriate for accountants to supply data on such things as cash and funds flows, differential costs, and variable

costs. This need for a variety of data does not, however, imply a need for variety of income concepts. Agreement on a meaningful concept of income is essential to improvement of the financial reporting function of accountants, and there is no inherent reason for this concept to interfere with the collection, analysis, and interpretation of data relevant to particular decisions.

Much has been written on the similarities and differences of appropriate income measurement for tax purposes and financial reporting purposes. There is substantial evidence that improvement of both taxation and accounting practice requires an income concept as a directional guide and that the same concept is appropriate for both. The term accretion was chosen for the income concept which appears most satisfactory for accounting because of this similarity between tax and accounting needs—the term has been used by some students of tax problems.⁷ The same general concept has often been called the "Haig-Simons" income concept after Robert Murray Haig and Henry C. Simons.⁸ This concept is particularly relevant to the growing concern about the need for income tax reform. The objectives of taxation include fairness or equity, desirable economic effects, and administrative feasibility. There is frequently a conflict between fairness and administrative feasibility which is closely related to (and often identical with) the accounting conflict between economic reality and objective measurability. In both accounting and taxation there is a need for a basic concept of income to be used as a direc-

⁷ E.g. Robert Murray Haig, "The Concept of Income: Economic and Legal Aspects," in R. M. Haig (ed.), *The Federal Income Tax* (New York: Columbia University Press, 1921), p. 17; and Richard A. Musgrave, *The Theory of Public Finance* (New York: McGraw-Hill Book Company, Inc., 1959), p. 165.

⁸ Robert Murray Haig, *op. cit.* and Henry C. Simons, *Personal Income Taxation*, (Chicago: The University of Chicago Press, 1938).

tional guide. General acceptance of such a concept would greatly clarify the issues in both tax and accounting controversies by separating the question of what is income from the question of how can we objectively approximate income.

The fact that income taxation is often modified in an attempt to bring about certain social or economic effects perhaps makes it hopeless that tax and accounting income will ever be identical. Whether or not it is *desirable* to use income taxation for such purposes is an issue which is not related to this article. In any event, it seems clear that insofar as we wish simply to tax income, the same need for soundness of concept and objectivity of measurement exists both for taxation and accounting. Academic and practicing public accountants face a real challenge in this area. If they take the lead in improving the soundness of accounting practice this not only will increase the fairness of taxation but also will reduce the danger of governmental regulation of accounting practices.

Much support can be found for rejecting the argument that measuring national income requires a different basic concept of income than measuring income of a business or other entity. It is reasonable to conclude that (a) the accretion concept is quite consistent with the general concept of national income and (b) the closer we can come to measuring accretion income of various entities, the more easily and accurately will we be able to measure national income.

The measurement of national income involves conceptual difficulties and also problems of using accounting figures to compute national income data. The most significant conceptual problems include aggregation and real versus money measurements.

Conceptually, aggregation is not a serious problem, though it is sometimes taken to be so. The problem arises from the fact

that what is true of the parts may not be true for the whole. For example, changes in relative prices result in real gains and losses to various entities but not to the entire economy and an exchange between a parent company (or a proprietor) and a subsidiary can change the economic position of each, but not that of the consolidated entity. This is a conceptual problem because of conceptual difficulties of defining the relevant entities, not because the data are inherently nonadditive. If we could, for example, measure the effects on each entity of relative price changes we would find that they could meaningfully be algebraically summed and that the total would always be zero.

Distinguishing real from mere money income when price levels change poses more serious conceptual difficulties. As noted in the preceding discussion of the accretion concept, accretion income (as defined here) does not deal directly with this problem. Accretion avoids the bunching of unreal gains that results from postponing recognition until realization, but does not attempt to measure the amount of unreal gains. It is probably more appropriate to attempt to make the necessary price level adjustments in computing national income than in computing entity income. The need for objectivity is perhaps less strict for the large aggregates being dealt with in national income computations, and the fact that the effects of relative price changes cancel each other perhaps eliminates the necessity of separating these from the effects of price *level* changes. Of course, the difficulty of defining and measuring the general price level is a problem which cannot be avoided.

The basic notion of the accretion concept is that income is any change in economic power that can be measured with reasonable objectivity. This does not appear essentially different from what we have in mind when we attempt to measure

national income. To the extent that we are able to approximate this for every entity in the economy we can measure national income by summing entity income. In this respect, progress toward the accretion concept would contribute to the improvement of national income data as well as entity income data.

Many controversies about income measurement stem from divergent interests of various parties. In addition to taxpayers versus the government there are, for example, unions versus management, utility shareholders versus consumers, and even management versus shareholders on occasion. In controversies of this type, the special interests of each party can be expected to lead to a bias in favor of methods of computation which will give desired results. This, however, does not justify a variety of income concepts but rather adds to the urgency of the need for a single concept as a standard. Income and financial position data are typically not the only factors relevant to necessary decisions in these controversies. Insofar as the decision hinges on a measurement of income, agreement on a concept of income is a necessary preliminary.

The accretion concept is very close to the concept of profit implied in the phrase "attempt to maximize profits." Though there has been a good deal of controversy about the objectives of businessmen, there can hardly be any doubt that it is usual and appropriate for a manager to be concerned about changes in the economic well-being of the entity for which he has responsibility. To the extent that businessmen attempt to maximize the economic position of their firms, as opposed to altruistic or social objectives, they are forced to use a concept such as accretion. Uncertainties as to the future (and even as to such things in the present as the shape of demand curves) make it generally impossible to measure income and economic

position in terms of present value of future receipts. To the extent that accountants can approximate accretion income, they can provide a measure of the things in which businessmen are interested. Further, if there is truth in the contention that businessmen often (irrationally, it would seem) attempt to maximize income as reported rather than economic income, then coming closer to the accretion concept would lead to an improvement in management decisions.

Implications for Accounting Practice. Acceptance of the accretion concept does not necessarily imply radical changes from present accounting practice. The concept itself does not tell us specifically what changes should be made, rather it provides a foundation for the decision by defining the income and economic position which we are attempting to measure. The definition does not state exactly when a change in economic position is measurable with "reasonable objectivity." This is inherently a matter of judgment on which we can never hope to achieve unanimity. We can expect such judgments to vary and to change as changes in markets and other institutions take place. The accretion concept requires us to face squarely the question of how much we are willing to depart from economic reality in order to attain objectivity and uniformity of method. The following discussion of possible changes in accounting practice reveals that in the present writer's judgment, significant changes in accounting practice ought to be made. These would result in a more realistic portrayal of income and economic position without serious loss of objectivity—in some cases both realism and objectivity can be increased. Disagreement with the judgments made does not necessarily invalidate the accretion concept nor make it less useful in distinguishing controversies over what is income from those over what is reasonable objectivity.

The asset cash does not pose serious income measurement problems. Its value is ordinarily measurable with a high degree of both objectivity and economic reasonableness.⁹ In the case of receivables it might be said that accountants already follow the accretion concept in their present practice. Because receivables are generally fixed in money amount, there is no problem of unrecognized increases in value. Decreases in value are possible and are recognized, as soon as they reasonably can be measured, by deducting allowances such as for bad debts and cash discounts. This is simply and appropriately a matter of asset valuation, not of matching costs and revenues.

Short-term investments in marketable securities can be valued at market with relative ease, and commonly are so valued when market is below cost. The accretion concept would require that market values be used whenever they are reasonably measurable regardless of cost. Whether market values are measurable with sufficient objectivity in a particular case is the critical question for income recognition rather than "realization." If the present usual practice of not recognizing gains until realized through an arm's length transaction is to be preferred, it is because market values are not reasonably measurable rather than because true income does not exist until so realized. The accretion concept requires the accountant to exercise judgment (as to objectivity) in each particular case while present practice avoids some of these decisions by relying on the (inconsistent) broad judgment that increases in value above cost are never measurable with sufficient objectivity while decreases generally are. The accretion concept will have significant effects on accounting for marketable securities, then, to the extent that it is decided that market values can be measured with reasonable objectivity. Very likely the change from

usual practice would be considerable.

Much of the same reasoning applies to inventories. Whenever values different from cost can be measured with reasonable objectivity they should be reflected in the accounts. The accretion concept, if accepted, could be expected to result in major changes in balance sheets and reported incomes even if objectivity requirements were quite severe. This can be demonstrated by showing that there are many circumstances in which market values can be measured with greater objectivity than costs.

Any attempt to assign a dollar amount to inventories, whether the amount is meant to represent cost or value, involves estimates and is subject to a margin of error. A conclusive demonstration that in a particular circumstance the margin of error is less for value than for cost would require research and analysis beyond the scope of this article. Such research should be encouraged. The possibility of this result can be shown by pointing out some of the inherent weaknesses in cost measures and relative strengths of value measures.

The principal difficulty in attempting to measure inventory cost is the problem of allocation. It is not an overstatement to say that common costs pervade all types of businesses and industries. The problem is perhaps most obvious in the case of joint products, but similar problems of allocating overhead and selling and administrative expenses are nearly universal. Allocation difficulties have caused accountants generally to refrain from including any "operating expenses" in inventory values and many advocate going further and not inventorying any fixed costs. The growing support for variable costing can be inter-

⁹ The problem of price-level change effects on real income is disregarded. In this writer's judgment, even a fairly severe inflation or deflation would not justify an attempt to come closer to "real" income than is accomplished by the accretion concept.

puted as evidence of the lack of reasonable objectivity in attempts to allocate fixed overhead to production and inventories. The most effective argument against variable costing is not that fixed overhead can be reasonably allocated but rather that variable costing inventory figures are not likely to be a reasonable approximation to value and therefore will result in a poor measure of income.

Another inherent weakness in attempting to measure costs is the problem of deciding which costs are appropriate. This is most strikingly demonstrated by the LIFO controversy. The failure of the concept of matching costs and revenues to constitute a concept of income is revealed by the fact that matching does not tell us which costs to match. The LIFO method can result in an artificial smoothing of income because it fails to reflect the real gains and losses resulting from fluctuations of inventory values, not because it matches costs and revenues improperly.

The basic reason for the non-objectivity of cost measurements is that cost allocations cannot be proved to be sound without reference to values. On the other hand, the difficulty of objectively measuring market values is often exaggerated. Vast amounts of inventory consist of materials and merchandise for which a market price is readily measurable. The difficulties are probably greatest for partly finished manufactured goods and for finished goods or merchandise when the time and terms of sale are somewhat uncertain. But in these cases the difficulties of reasonable cost allocations are also likely to be serious, and it is not obvious that costs can be more objectively measured than values. Extensive research into these problems should prove valuable.

The case for using cost on grounds of objectivity is much stronger for fixed assets than for inventories. Because fixed assets are relatively unique and infre-

quently exchanged, market valuations are typically subject to considerable uncertainty. This undoubtedly justifies generally adhering to cost as the most reasonable approximation to value. It might be argued that even when significant changes in value can be measured with reasonable objectivity, cost should be retained in order to achieve consistency or uniformity of method. This is not convincing. Even when every entity reports fixed assets on a cost basis, comparability is not achieved because different entities acquire assets at different times and prices. Universal adherence to the cost basis thus achieves neither reasonable measures of income nor comparability. Freedom to reflect objectively measurable value changes, even if permitted only in highly restricted circumstances, would conceptually improve both income measures and comparability.

The accretion concept might not have a great effect on accounting practice in recording intangibles, such as patents and research and development, because we are already pretty close to this concept for these items. Thus, insofar as research and development costs exceed the reasonably measurable value of the resulting assets, we are forced to use an "accretion" measure of the asset, unless we plead conservatism and record a nominal amount. In the latter case we cannot also claim to be attempting to measure income fairly. Where the reasonably measurable value of intangible assets exceeds cost, the accretion concept calls for a change from usual present practice.

Another area in which accounting practice could be affected is the recording of lease obligations and corresponding assets. Again, the question becomes one of judging reasonable measurability of the asset and liability (and any corresponding effects on income) rather than a question of whether the asset or obligation exists.

On the whole, general acceptance of the

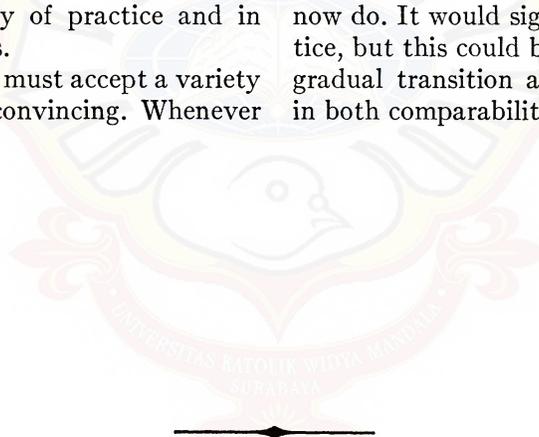
accretion concept, and the corresponding relegation of matching to a minor role as an occasionally useful technique rather than a concept of income, would have significant effects on accounting practice. On balance, the result might well be a gain rather than a loss of objectivity, and improved comparability as well as economic reasonableness would certainly result.

Conclusions. Needed improvement of accounting theory and practice is unlikely to be achieved unless accountants are able to reach general agreement on a concept of income which both conforms well to economic reality and is measurable with reasonable objectivity. The accretion concept meets these requirements. The failure of the concept of matching costs and revenues as a concept of income is reflected in both the present diversity of practice and in theory controversies.

The claim that we must accept a variety of purposes is not convincing. Whenever

the purpose is such as to require a measure of economic position and income, a single concept is appropriate. This is not the same as to say that measurements of economic position and income provide all data relevant to all decisions. On the contrary, management, investors, and others often require quite different data for various purposes. Insofar as accountants attempt to report financial position and income, it is necessary to have a meaningful single concept of income.

Although the accretion concept does not serve all needs for data, it has a striking degree of universality of applicability in many areas including taxation, national income measurement, and management decision-making. Acceptance of the accretion concept would not require a sudden overturning of most of what accountants now do. It would significantly affect practice, but this could be brought about by a gradual transition accompanied by gains in both comparability and reasonableness.





AMERICAN ACCOUNTING ASSOCIATION

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COMMENTS ON "THE ACCRETION CONCEPT OF INCOME"

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Introduction. The recent article on the "accretion" concept of income by Professor G. Edward Philips calls for a reporting revolution—the recognition of a new, single concept of income for financial reporting by public accountants.¹ Several recommendations for improving accounting theory and closing the gap between theory and practice are also timely, coming on the heels of the Sprouse and Moonitz Accounting Research Study No. 3—"A Tentative Set of Broad Accounting Principles For Business Enterprises." Although this writer finds himself in general agreement with the objectives and approach suggested by Professor Philips, his *accretion* concept of income must be significantly modified in one important respect if it is to be theoretically sound and generally useful in practice.

The main purposes of the following short comments are: (1) to encourage widespread acceptance of Professor Philips' objectives and general approach, (2) to suggest the necessity for measuring net income in real rather than in absolute dollar terms, except when price levels do not change significantly, and (3) to present a few comments on the income-tax and goodwill problems which arise in this context.

The accretion concept. The Philips article demonstrates quite well that progress in accounting theory should begin with developing a single income concept, rather than a variety of income concepts; and that this single income concept should also aid various interested parties in making a variety of decisions. His point that simply because accountants must supply varied

data for many different uses, does not imply a need for more than one concept of income is well taken. He says: "Agreement on a meaningful concept of income is essential to improvement of the financial reporting function of accountants, and there is no inherent reason for this concept to interfere with the collection, analysis, and interpretation of data relevant to particular decisions."

After discarding the "psychic" and "economic present value" concepts of income, because of their subjectivity (a reasonable approach at this juncture in history), Professor Philips chooses the *accretion* concept of income, defining it as "an increase in economic power which can be measured with reasonable objectivity." Economic power refers to net assets; reasonable objectivity of measurement means reporting objectively determined market values of assets. Further, the measurements are to be made in dollar, rather than real (or purchasing-power) terms. This accretion concept is called the "ideal concept."

Measurement in real terms. The suggestion to use *objective* market value changes for the realization of profit or loss is a significant step forward, but material changes in the value of the dollar should *not* be ignored. Price level changes could readily have been included in the definition simply

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by inserting the economic term "real." Then, income would be the increase in *real* economic power which could be measured with reasonable objectivity.

This change is required if the concept is to be theoretically sound. A yardstick of changing size is unsound. Past experience with inflation and deflation indicates that measurement in real terms is often required if income statements are to be useful for decision-making. We are all familiar, for example, with the fallacy of the homeowner who bought a house in 1945 for say \$10,000, sold it for \$19,000 in 1950, and believed that his \$9,000 dollar "gain" was real until he searched for new housing.

Professor Philips does not ignore the price-level problem in his paper, but concludes that even a severe inflation or deflation would not necessitate eliminating unreal gains or losses from income statements. He also states that his suggested accretion concept eliminates the "bunching" effect of realizing periodic accretion gains all at one time, as is presently done. The following current illustration, which is probably realistic for assets in general, shows that he is probably in error on the first count, but correct on the second.

Consider a \$100,000 investment in a listed security whose value can be deter-

mined objectively. It rises 10 percentage points a year for ten years, during a period when the general price level rises 5 percentage points a year. At the end of the tenth year the investment is sold for \$200,000. The income determined under three concepts, the conventional "cost" concept, the accretion concept, and the purchasing power (or real) concept is compared for the 9th and 10th years in Table I below.

It is of course true that some assets recently have risen much more rapidly than has the general price level; these cases illustrate Professor Philips' contention, but are extreme cases. If, for example, an investment in Waikiki or Palm Springs land rose 80% (from \$40,000 to \$72,000) during a year when the general price level rose 5%, the accretion concept would show income of \$32,000; whereas, the real income concept would reveal \$30,000 income. This difference of \$2,000 probably is not significant; but again, this is not the usual case. Although prices in the economy vary widely, giving rise to extremes such as the land cases, prices generally follow a central tendency. Most prices cluster near the 5% general price level average change. The first illustration is the more typical. Thus, many accretion "gains" will be unreal, and

TABLE I. INCOME COMPARISONS

Year 9:	Conventional "Cost" Concept	Accretion Concept	Real Income Concept	
Value-ending.....	\$100,000	\$190,000		\$190,000
Value-beginning.....	100,000	180,000	\$180,000	
Price Level Increase.....			5,000*	185,000
Income.....	None	\$ 10,000		\$ 5,000*
Year 10:				
Sales Price.....	\$200,000	\$200,000		\$200,000
Value-beginning.....	100,000	190,000	\$190,000	
Price Level Increase.....			5,000*	195,000
Income.....	\$100,000	\$ 10,000		\$ 5,000*

* Of the \$10,000 increase in value each year, \$5,000 is an asset and owner's equity revaluation, and \$5,000 is a real gain.

economic decisions based thereon may be in error.

Income tax. The problem of income taxation is a case in point. Assume that the first illustration of the \$100,000 investment represented a business inventory (rather than common stock). The accretion concept would subject the company to \$10,000 taxable income each year, whereas the real income concept would report only \$5,000 taxable income. The firm's owners are really not \$10,000 wealthier each year if \$5,000 of this amount is required merely to maintain the original purchasing power of their investment in the business.

Some businessmen will go further, arguing that none of the annual \$10,000 accretion should be taxed, because it now takes \$10,000 more to replace the specific asset. They argue that a specific index of purchasing power should be used for each asset, rather than a general purchasing power index. This approach appears to go too far; it asks for too much. All capital gains would be 100% tax free. Any business investment which rose in value while it was held, even speculative investments in oil wells, patents, securities, or land would completely escape income taxation. It seems that although taxation of the full accretion gain would be unrealistic and unfair, taxation of the gain in purchasing power (real "economic power") is reasonable. This might necessitate business borrowing to pay taxes, but the collateral then would exist, and this practice is not at all new.

Goodwill. A final comment. As mentioned earlier, Philips chose the accretion concept as his "ideal" concept. If we eliminate psychic income measurement as being too far out at the present state of knowledge, economic present value income probably

is a better candidate for the "ideal" concept. Market values of assets are approximations, based on estimates of future revenues and discount rates by various participants in the market. As Philips implies they would equal discounted values were it not for individual differences and errors. Therefore, market values may be regarded as approximations or estimates of present values.

In order for economic present value income to be determined, it would be necessary to calculate the discounted value of all assets each period, including the asset goodwill. Then the sum of the values of the net assets would equal the discounted value of all future net receipts for the entire business. This is another reason why the economic present value income concept is usually rejected in practice—the difficulty of assessing goodwill.

Since the accretion concept requires objective measures of asset values, goodwill changes would not be included as a part of accretion income. This means that the accretion concept loses more of its claim to being "ideal." It also means that unless goodwill always remained constant, accretion income would not equal present-value income, even if all people in the market evaluated individual assets alike.

Conclusion. It must be concluded that Philips' accretion concept of income, when measured in real terms, is a realistic and practical, single, general-purpose concept of income. It has theoretical validity, as well, if changes in the value of goodwill may legitimately be ignored. It represents a significant improvement over the conventional historical-cost-basis concept of income, since the latter is both theoretically unsound and practically misleading whenever prices change significantly.
