Income Measurement

Part 3

Your goals for this "Income Measurement" chapter are to learn about:

- "Measurement triggering" transactions and events.
- The periodicity assumption and its accounting implications.
- Basic elements of revenue recognition.
- Basic elements of expense recognition.
- The adjusting process and related entries.
- Accrual- versus cash-basis accounting.

12. "Measurement Triggering" Transactions and Events

Economists often refer to income as a measure of "better-offenses." In other words, economic income represents an increase in the command over goods and services. Such notions of income capture a business's operating successes, as well as good fortune from holding assets that may increase in value.

12.1 The Meaning of "Accounting" Income

Accounting does not attempt to measure all value changes (e.g., land is recorded at its purchase price and that historical cost amount is maintained in the balance sheet, even though market value may increase over time -- this is called the "historical cost" principle). Whether and when accounting should measure changes in value has long been a source of debate among accountants. Many justify historical cost measurements because they are objective and verifiable. Others submit that market values, however imprecise, may be more relevant for decision-making purposes. Suffice it to say that this is a long-running debate, and specific accounting rules are mixed. For example, although land is measured at historical cost, investment securities are apt to be reported at market value. There are literally hundreds of specific accounting rules that establish measurement principles; the more you study accounting, the more you will learn about these rules and their underlying rationale.

For introductory purposes, it is necessary to simplify and generalize: thus, accounting (a) measurements tend to be based on historical cost determined by reference to an exchange transaction with another party (such as a purchase or sale) and (b) income represents "revenues" minus "expenses" as determined by reference to those "transactions or events."

12.2 More Income Terminology

At the risk of introducing too much too soon, the following definitions may prove helpful:

- Revenues -- Inflows and enhancements from delivery of goods and services that constitute central ongoing operations
- Expenses -- Outflows and obligations arising from the production of goods and services that constitute central ongoing operations
- Gains -- Like revenues, but arising from peripheral transactions and events
- Losses -- Like expenses, but arising from peripheral transactions and events

Thus, it may be more precisely said that income is equal to Revenues + Gains - Expenses - Losses. You should not worry too much about these details for now, but do take note that revenue is not synonymous with income. And, there is a subtle distinction between revenues and gains (and expenses and losses).

12.3 An Emphasis on Transactions and Events

Although accounting income will typically focus on recording transactions and events that are exchange based, you should note that some items must be recorded even though there is not an identifiable exchange between the company and some external party. Can you think of any nonexchange events that logically should be recorded to prepare correct financial statements? How about the loss of an uninsured building from fire or storm? Clearly, the asset is gone, so it logically should be removed from the accounting records. This would be recorded as an immediate loss. Even more challenging for you may be to consider the journal entry: debit a loss (losses are increased with debits since they are like expenses), and credit the asset account (the asset is gone and is reduced with a credit).