

DEVELOPMENT OF A CRITERION FOR THE REALIZATION CONCEPT

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Setting of the Problem: The Realization Concept

The concept of income and its determination for purposes of financial reports is generally regarded as the core issue of most accounting matters.

Revenue is the foundation of income. In accounting literature, concepts of revenue show a considerable dissimilarity. The definitions differ not only on the basis of the types of events that are included as revenue events, but also with respect to the direction of the value movement that is viewed as revenue.

Revenue is recognized and available as a potential source of income when it is "realized". The concept of realization is an integral part of the process of income measurement. In accounting literature the realization concept shows much variation, and considerable confusion exists as to its precise meaning and criteria. In this connection, Windal points out that:

It is in this area of technical accounting usage that a great deal of confusion exists as to the precise meaning of the terms. Although some accountants speak quite freely of 'realizing revenue or income',

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other accountants are not always sure exactly what they mean. Some give the expression one meaning, while others give it another. (1)

Although it is universally recongnized that the realization concept is vitally important, it was conspicuously missing from **Accounting Research Study No. 1. 2** Moreover, in **Accounting Research Study No. 3**, the authors state about realization:

We will use the term occasionally because its use is so deeply imbedded in accounting terminology, but we cannot accept it as an essential feature of accounting because the concept lacks analytical precision. (3)

Again, in 1965, Sprouse wrote:

My own view is that in establishing criteria for the **recognition** of revenues the concept of realization is awkward - causing confusion rather than creating clarity." (4)

On the other hand, Richard Mattessich, (5) where mathematical logical approach has been considered by many as a real contribution to accounting theory, subscribes to the premise that realization is one of the basic assumptions of accounting. Edwards and Bell(6) recognized the place of the realization concept as important in income determination.

Hence, some fundamental issues are at stake : 1) Does realization "exist"? 2) Is it a useful accounting concept? 3) Is there a need for the realization concept? 4) Do two opposing concepts exist: realization and recognition? Is there a valid criterion for testing realization?

A CRITERION FOR REALIZATION

It seems to the writer that these questions would yield to additional research efforts. However, the rest of the paper is devoted to answer the criterion question. The author seeks to develop his own criterion which strives to be theoretically sound and practically realistic.

The author defines revenue as follows:

Revenue is an increase in the value of assets or a decrease in the value of liabilities that result from sale, exchange, utilization or holding during the accounting period, and its measurement process relies on wise, reasoned, and informed professional judgment.

This definition concerns an increase in the value of the assets or a reduction of liabilities. It includes change in value arising from change in general purchasing power and in individual prices. Revenue is used in the sense of gross revenue. This definition would encompass the recognition of revenue resulting from the transfer of an asset, the performance of a service, the use of a resource of the firm or application of asset value.

This is an all-inclusive definition of revenue. It can be applied to all the activities of the firm and to all types of businesses. It will serve as a guide to action without classifying some procedures as exceptional. It will have a striking impact on the practical problems of revenue recognition. This definition does not depend upon a particular event, nor does it rely on the receipt of a particular kind of asset. Measureability, not liquidity, should be emphasized as the essential attribute required for recognition of revenue. The definition is an attempt at a universal and basic concept for recording revenue in the accounts. It does not rule

out the use of the point of sale for the recognition of revenue. It can be applied in the case of long-term construction projects, advance orders from customers accompanied by partial or complete cash payments, magazine subscriptions or season tickets, et cetera. It recognizes that revenue is derived from the whole of business activity.

From this definition, it is possible to develop a major criterion - for - realization test of revenue recognition. Two major factors are involved. They are:

- 1) Increase or decrease in the value of an asset or a liability.
- 2) Dependence of the measurement process on wise, reasoned, informed professional judgement.

This definition does not require the presence of an exchange transaction for revenue recognition. Any change in the value of an asset or decrease in the value of a liability which can be measured with reasoned, informed professional judgement will be recognized and reported in the income statement. Any change which cannot be measured with reasoned, informed professional judgement will not be recognized or booked. Under this definition there will not be unrealized revenue income.

This position will be defended in the following sequence:

- (1) objectivity and professional judgement; (2) revenue measurement; (3) measurement of changes in the general price level; and (4) reporting changes in value.

Objectivity and Professional Judgement

Professional judgement is interpreted as:

The ability to make a decision or form an opinion relating to the measurement of revenue after exami-

ning all attendant considerations, some of which may be objective and some of which may be subjective, or all of which may be subjective or objective.

Thus, the term "judgement" in no way relies on intuition or vague feelings, but rather professional judgement based on knowledge, wisdom, reasoning, expertness, competence, and experience. What should be emphasized is good judgement, competence, integrity, and carefulness in revenue measurement. Reliance on "objective evidence" only should be abandoned. "Objectivity" should not be considered an absolute term but a relative one necessitating professional judgement for interpretation.

In accounting literature objectivity is usually regarded as an important criterion for choosing among measurement methods. For example, Moonitz states:

Change in assets and liabilities, and the related effects (if any) on revenues, expenses, retained earnings, and the like should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms(7).

Further, Moonitz defines objective evidence as being subject to verification by a competent investigator.(8) Paton and Littleton's definition of objectivity is similar to Moonitz's. They write:

"Objective" as used here relates to the expression of facts without distortion from personal bias... "objective evidence" therefore is evidence which is impersonal and external to the person's unsupported opinion or desire. (9)

However, objectivity is a difficult concept to define and, in

some cases, leads to disagreement and confusion. Ijiri and Jaedicke define objectivity to mean "the consensus among a given group of observers of measures." (10) They admit various degrees of objectivity and consider the important issue to be whether one measurement is more objective (or less objective) than another and not whether it is absolutely objective.

Wagner's definition is more precise:

1. Objectivity in accounting is a quality said to exist when financial data are presented in a manner that produces a highly reliable connection between the events taking place in a given business entity and the mental image created in the user's mind about these events.
2. Objectivity in financial presentations is attained by the individual practitioner through the competent and ethical exercise of professional judgement in conjunction with reference points (procedures and principles) socially prescribed by the members of the profession as a corporate body. Attainment of a reliable connection between the events being reported and the user's understanding of these events is the goal for which we strive in regard to objectivity. (11)

Further, Wagner emphasizes that the distinction between an objective or subjective presentation should not be based on the presence or absence of judgement, but on the circumstances that surround the use of judgement. Moreover, he considers objectivity useful if it is examined "as quality emerging from a social-psychological process of perception." (12)

Current practice requires objective evidence before recording a transaction. All assets have to be recorded at cost. The requirement that gains be "realized" before they are recognized is one facet of objectivity.

Revenue Measurement

Revenue measurement should rely on wise, reasoned, informed professional judgement. In the presence of a market transaction, revenue should be recognized according to conventional accounting principles. In the absence of a market transaction, revenue should be recognized according to some measure of **current attainable economic significance**. This does not require a specific measure, but recommends the use of any **attainable and feasible** measurement which in the accountant's judgement is satisfactory. There are many possibilities, such as the present value of expected cash flows, opportunity cost, replacement cost, net realizable value, market value, and the present market resale (exit) price.

It should be emphasized that the intention here is to use different valuation methods for the various types of assets by the company.

It should be noted that true and accurate measures are not attainable. The accountant, however, should apply his reasoned, informed, wise judgement in the measurement process of revenue. These attainable measures mentioned above, have been used in practice successfully, they give meaningful financial statements, and they have been recommended by authoritative bodies and by different research finding. (13)

The only serious objection to this suggestion is that similar assets employed by different companies might be valued by dif-

ferent methods, thus impairing comparability between firms. It is questionable whether this loss would be serious. However, to avoid it, firms would be required to make full disclosure of the different methods they used to evaluate all types of assets.

Measurement of Changes in General Price Level

Revenue has been defined as the increase in the value of an asset and decrease in a liability. One should adjust for changes in the general price level before bringing the assets to current replacement cost, opportunity cost, present value, net realizable value, present market resale price, et cetera, and the liabilities to present values. Changes in the value of an asset should be divided into two main categories, viz., "price-level increase", and "invisible capital value" to be discussed later.

Concerning the liabilities, especially long-term obligations, the amount for bonds is always exact since it expresses a legal relation. The business enterprise can only be obliged to pay back the bonds in terms of nominal dollars. However, the depreciation of the purchasing power of the bonds constitutes an element of revenue for the firm which should be recognized and reported.

The question of adjusting assets value to show the effect of changing price levels will become very important in the period ahead because an unstable monetary unit is a constraint on the application of accounting principles logically derived from the premise of a stable measuring unit. Present accounting asset valuation in financial statement.

The failure of accounting practices to identify the measurable changes in the price levels has caused important undesirable economic and social effects.

Reporting the Changes in Values

It is recommended that changes in values arising from changes in general purchasing power and in individual prices be recognized and recorded in the accounts. Under the concept of revenue developed in this paper, there are no such unrealized changes in the value of assets. As long as the accountant has relied on reasoned, informed, wise judgement in the revenue measurement, revenue should be recognized and recorded in the books. The effect of all value changes must be included in the calculation of net income.

An income statement form that would report operating income, price-level increases or decreases (movements in the general price level), and "invisible" capital values (movements in individual prices) separately and which would add the three to obtain the net income figure, is recommended. With this form, management can make better decisions and the investor can better rely on the published financial statements to make financial decisions.

The income calculated according to the realization concept developed in this paper will differ from taxable income since taxes are calculated on the basis of historical cost. But it is not unusual for major differences to exist between a firm's tax returns and its published financial statements.

This realization concept is also important in relation to a firm's dividend policy. When profits are computed on the basis of this concept, management could be expected to distribute more dividends.

Summary and Conclusions

In this paper, revenue is defined as follows:

Revenue is an increase in the value of assets or a decrease in the value of liabilities that result from sale, exchange, utilization or holding during the accounting period, and its measurement process relies on wise, reasoned and informed professional judgement.

From this definition a major criterion for realization is developed as follows:

- (1) increase or decrease in the value of an asset or a liability.
- (2) dependence of the measurement process on wise, reasoned, and informed professional judgement.

Professional judgement is interpreted as follows:

The ability to make a decision or form an opinion relating to the measurement of revenue after examining all attendant considerations, some of which may be objective and some of which may be subjective, or all of which may be subjective of objective.

It should be emphasized that a market transaction is not necessary for revenue to be realized. In the absence of a market transaction revenue is recognized according to some measure of Current attainable economic significance. No specific measure is required. It is recommended that any attainable and feasible measurement which, in the judgement of the accountant, is satisfactory, should be used.

As to reparting the changes in values, an income statement form that would report operating income, price-level increases (movements in the general price level), and invisible capital values (movements in individual prices) separately and which would add the three to obtain the net income figure, is recommended.

FOOTNOTES

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13. For explanation see Edgar O. Edwards, and Philip W. Bell, **The Theory and Measurement of Business Income** (Berkeley and Los Angeles: University of California Press, 1961), PP. 34-38; M. Moonitz and J. H. Jordan, **Accounting. An Analysis of its Problems**, Volume 1, Revised Edition (Holt, Rinehart & Winston, 1963), PP. 164-165; A. Goudekot, "An Application of Replacement Value Theory", **Journal of Accountancy** (July, 1960), P. 38.

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