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By Percy D. Mitchell

Attention in industry as in the home centers to-day around the high cost of living and stereotyped as its discussion has become it will not cease to hold our interest until its effects have been dissipated. In most manufacturing and commercial industries selling prices have, in true accord with economic laws, kept pace with purchase and productive costs and thereby have maintained income ratios. Actually such concerns have increased profits, speaking generally, but are perhaps no better off if those profits are measured in terms of purchasing power. Naturally the stockholder as such finds himself in much the same position, though perchance conservative directors, having in mind probable days when demand does not so greatly exceed supply, have for the time being sacrificed him for the benefit of the corporation.

But what of those corporations, institutions, estates and individuals whose income largely arises from long-term investments relatively safe and of correspondingly low returns? Where such investments are found, an income which has not varied with rising costs exists. Money values have changed, to be sure; but with that change has fallen the value of many strong investments to the point where the loss which would attend their sale offsets any advantage in income that might attend current purchases. Thus not only has the income of these concerns not increased in purchasing power but also no increase has occurred when measured only by the dollar.

Among such unfortunates are banks and eleemosynary institutions. Of banks the smaller, particularly state banks, such as those devoted entirely to savings deposits, have suffered most. Trust companies and national banks have benefited by the increase in successful business to an extent partly offsetting rising

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costs. But the less liquid savings bank has found its only relief in increased deposits which have enabled it to purchase at the present advantageous market. But little immediate benefit has been derived as, excluding amortization, it must wait for much of the increment so obtained until the purchased securities mature. On the other hand its expenses, for the most part small, consisting largely of salaries, have been slow to increase.

But in the case of eleemosynary institutions costs have mounted rapidly while the large portion of income derived from securities has not followed suit. With them the ratio of income to expense has become an acute question. It is therefore pertinent to consider their income accounting.

Further reason for inspection of accounting for income exists at this time because of the approach of a period of depression which economic history indicates will follow present expansion of production and inflation of values. That such a period may be particularly grievous is deducible from the already strained conditions of transportation corporations and public utilities generally. Probably more than fifty per centum of the income from securities held by savings banks and eleemosynary institutions is derived from such corporations. Foresight therefore demands preparation for properly recording income due, but unpaid—income in arrears.

Inasmuch as the scope of this thesis scarcely allows for developing in detail the peculiarities and necessities of more than one accounting system, directness of treatment will from this point be applied only to eleemosynary institutions and of them only to the college or university. It is hoped thus concretely to present a method of accounting for income which will admit of ready adaptability to other institutions and to banks and other organizations where income from securities is a considerable item.

Income accounting might be construed to cover many forms of income based on the various sources from which it comes; but each form has its own peculiar problems. For that reason, discussion here will be limited to that income which is derived from securities such as stocks, bonds and mortgage notes. Income from rents may be considered as included if it be borne in mind that supporting statistical information is more important relatively than in the case of bonds, for instance.

There are several methods in use for accounting for these incomes: cash, accrual and amortization combined with the accrual method. And there is another method which combines the cash and accrual methods. For the purposes of this discussion amortization will be considered only by saying that in ordinary circumstances its practical application is doubtful for the three reasons that it requires time which institutions can ill afford; that it accrues income that may never be received; that it accrues income the cash from which is not available for expenditure.

The cash method is most widely used, for it meets effectively those difficulties which amortization encounters: it is simple, requiring a minimum of time; it is certain, meeting all demands of conservatism and in no way forestalling donations by income inflation; and lastly it does not record the income until it is available for use. This last is important for the income of institutions is rarely adequate. Indeed someone has said that no self-respecting institution would operate without a nominal deficit. And where the income, as it frequently is, is wholly or partly restricted, the cash method is nearly imperative.

On the other hand the cash basis alone is inadequate. Granting its advantages of ease of operation, conservatism, availability for use—the question next arises: Does it properly safeguard receipt of income?

Certain it is that any system of accounts which does not take cognizance of all important details is inadequate. Inadequacy is particularly reprehensible in institutions, recipients of charity; and in no other type of organization, excepting possibly banks, does incompleteness bring its dire results so surely. Thus, through defective accounting a manufacturing corporation suffers a cashier to embezzle a certain sum of money and measures its loss by that sum. Its sales or income are in no other way affected. But let a charitable institution through no more neglectful methods stand such a loss and its goodwill in obtaining donations is impaired for an indefinite period.

Where income is actually received regularly when due, the cash method does supply a fairly safe record. But where such items are numerous and defaults occur the cash method fails to leave a clearly defined record of arrears. This objection may be met by accruing the income as it becomes due; but this method encounters two of the difficulties already discussed: the income is inflated and it is unavailable. Moreover it creates the impression of availability and it inflates the income at the time when there is the least probability of its being received.

There remains for consideration, then, the other method which combines the cash and accrual ideas. In practice some attempt is often made to use this method in a sort of hit-or-miss way, but rarely is it found an integral part of the accounting. Nevertheless it can be applied without unduly increasing the time and labor of bookkeeping, without inflating income, and without distributing income until it is available. Furthermore, it will supply a complete record—and that which is complete can scarcely fail to be adequate.

There are two other desiderata which combining the cash and accrual methods supplies as well as or to greater extent than either method alone: continuity and availability. The very nature of the income accruing in regularly repeated intervals in the same amount requires a continuous record to be properly intelligible to financial committees and other trustees of institutions, frequently so busily engaged with their own affairs that only perfunctory or occasional attention is given to affairs of trust. Thus even an auditor's report that certain income for the year just ended has not been received will be noted for the moment but will not be followed up during the current period. To effect continuity all income not received must be carried forward to following periods.

Such a continuous record is easily available both to officers and to auditors. If all the income that could possibly be received has been charged, one account can be used to indicate that fact. The treasurer, trustee or other officer can determine the status at a glance. The auditor, too, can readily check the whole matter; whereas under the cash method he must somehow build up the accrual method to insure completeness. It may not be axiomatic but it is a fairly safe rule to follow that that method which audits most readily has superior qualities.

In effect, combining the cash and accrual methods means that although the income is accrued as it matures, it is not distributed for disbursement until it has been actually received. The formula for accomplishing this is two-fold: (1) make the accrual method an integral part of the double-entry accounting: (2) arrange the income register to account as well for principal as for income. In other words the income register should be a detail investment ledger to the extent that it records in every instance changes in principal and is the basis of double entries re matured income. Indeed, in institutions with several millions involved, it may when supplemented by proper statistical records serve as the investment ledger, and that ideally, because combining simplicity and small amount of labor.

To make accrual accounting an integral part of the double-entry system it is necessary to charge the accruals to some balance-sheet account, with the stipulation that a reversal of the entry may not be made except by express vote of the finance committee or trustees. In other words, it is not enough to use memorandum accounts: i. e., offsetting debit and credit accounts which are eventually eliminated by simply reversing the originating entries.

The method to use can be best explained by illustration.

(a)	Income receivable,	xxx	
	To income matured,		xxx
(b)	Cash,	xxx	
	To income receivable,		xxx
(c)	Income matured,	xxx	
	To sundry income accounts,		xxx

By this method income receivable is charged, entry (a), with all income as it matures. That account is then accountable for in cash, entry (b), and no other credits should be allowed except by recorded vote of finance committee or other trustees. Income receivable may sometimes and after a period probably would contain two elements, income receivable in arrears and income receivable to be received or slightly delayed. Distinction, of course, should be drawn, and to that end the trustees once a year might authorize transfer to a separate account of that income in arrears which it is believed will scarcely be received soon if at all. Such income would be that from bonds of corporations in default and undergoing reorganization and from mortgages in process of foreclosure.

Here a word may be added regarding the advisability of accruing income after default. It is maintained that, if it is not distributed for disbursement, it should be accrued, for that is the very essence of the problem and to lapse at such a time would impair the method to the point of making it almost futile. Until otherwise authorized the treasurer should be accountable for all the income from a security exactly as if the debtor corporation had not defaulted. And, since income is not distributed for disbursement until received, no false hopes are developed. Many reorganizations arrange to pay the income in default either at a reduced rate or in securities. Where the medium is securities, care should be used in their valuation for entry.

But it is not enough that the income register be the basis of the double-entry income accounting. If it does not serve the further purpose of an investment ledger it must be self-demonstrating that its totals both par and book agree with the investment control or balance-sheet just as truly as a ledger does. This statement would seem so axiomatic that it need not be emphasized; but in practice such correlation has been found lacking. This important deficiency has in such instances appeared to result either from incompetency (failure to understand the importance of such correlation) or from faulty methods. By this phrase is meant the inadequacy so frequently found as the effect of old methods, once sufficient perhaps, but now outgrown. Endowment funds have grown largely during the past two decades and not always has the accounting therefor kept the pace.

In still another way should the income register be tied to the balance-sheet—the income matured and unaccounted for currently must be properly forwarded, the balance forward agreeing with the debit balance of the balance-sheet account income receivable which was charged by entry (a). It is not enough simply to leave blanks, unchecked items, etc., to represent income in arrears—each period's deficiency must be carried forward and charged to the period following. This may be done by summarizing the debits and credits for each period and forwarding arrears as one does a cash balance or by arranging the register so that the columns provide the necessary balance plainly without summary.

At this point consideration may be given to the inclusion of arrears income in the balance-sheet as a policy of the institution. For internal purposes—for the treasurer, finance committee, president, auditor and others—there seems every reason for its inclusion. But where it is the custom to print and to distribute a treasurer's report which ought—though frequently like those of municipalities it does not—to contain a balance-sheet, objections may be raised that such inclusion might by giving impressions of a financial prospect more hopeful than warranted and of mismanagement forestall donations. This is serious reason but of doubtful weight. It is to be assumed that such balance-sheets are of interest primarily to an intelligent class of people who should for the most part be able to read properly a well expressed balance-sheet. If, then, care be used to indicate clearly the nature of the item of arrears income and its corresponding reserve, no misunderstanding ought to arise. Or if anything further be thought necessary, brief comment in the written report might explain.

Attention to the position of income receivable on the balance-sheet will do much to avoid misconceptions. On the asset side it should be analyzed, as already mentioned, to show current income overdue and arrears income the receipt of which is doubtful, the former being a current asset and the latter an item of suspense or contingency. On the liability side, the credit account income matured but not received may appear as deferred income if the item be current; but, where the debit or portion thereof is carried as suspense, a corresponding portion of the credit should be used as a valuation reserve. Careful consideration of attendant prospects of receipt will determine which position is preferable.

As to the question of suggesting mismanagement, if mismanagement has occurred, the potential effect of publicity might prevent its recurrence and, while there might be exceptions, incidental publicity such as would accompany distribution of a balance-sheet should be given, unless well founded reasons can be assigned for not doing so. But it should be clearly understood that an arrears balance not unduly large does not indicate mismanagement necessarily, for the very nature of the income under consideration implies the risks of judgment.

Inherent in the correlation of the income register and the balance-sheet is the problem of handling the so-called uninvested portion of funds. Frequently this phraseology is used to designate investment of a temporary nature such as savings deposits, certificates of deposit and the like. These deposits occurring at the inception of a fund, at the time of addition of a portion of the income, at the maturity of some investment, or of some portion, as in the case of serial bonds and part payments on mortgages, and at the time of investment by reason of the purchase price not exactly coinciding with the amount available for investment, usually are made only until fit opportunity for more permanent investment is found. But since such underinvestments frequently produce income, they should be handled exactly as investments for longer terms. In fact, whether they produce income or not, they are accountable in the usual way for the two reasons that they are potential producers of income and that the income register must be in continuous accord with all balance-sheet figures appertaining to investments. It is to be noted further that such items as result at times of investment from the fact that purchase prices fall somewhat short of the uninvested cash available are often quite as permanent as the investment, but are usually small.

To accomplish proper recording of such uninvested portions care must be used in segregating them according to funds. In the case of a larger amount this separation should be made by the actual deposit of the cash by itself as well as in the accounting records, although it is expected to retain its integrity for only a short time. Even where the items are small, such segregation should be made on the books, but it may be found impracticable to keep eight-cent cash balances separate or to account for the income on each two dollars separately. The process of consolidation should, however, be employed sparingly and with discretion.

Proper attention to details as outlined in the foregoing paragraphs should leave a record of all income that ought to have been received and thereby supply an adequate basis for proving that it had been received. It remains to record as accurately its distribution after receipt. It is not within the scope of this thesis to deal with voucher systems and the like supporting the actual disbursement of the income received, but rather to study at this point the condition attending the entry appearing above as transaction (c):

Income matured,	xxx	
To sundry income accounts,		xxx

The function of this entry is to distribute among the various income accounts the income to which they are entitled when it has been received. By income account reference is made to the elemental income account of that triad fundamental to all fund accounting: fund, investment, income. The relationship of that triad entitles the income account to all the income received from the investment. (The word "received" is used advisedly, on the basis of the preceding discussion of the relative methods of recording income accrued and income received.) And, when that has been accomplished by entry (c), the same relationship entitles the same income account to an explanation of the use of the income. In other words, disbursements under the fund may be made only as directed by the conditions of the fund and when so made are chargeable to the income account. A bookkeeping detail is met here: i. e., where such disbursements are numerous it is often expedient to charge them directly to a special account or accounts which are later in total closed to the income account.

These charges to income account are sometimes by the terms of the fund carried to principal or are payments to beneficiaries subject to life interests. The latter present no problems within our present discussion, as the payment ordinarily terminates the transaction; but the former supplies some of the cash mentioned above as uninvested. Auditors should note here that investment of this cash or its deposit at interest should follow the date of its receipt very closely.

Charges other than those just mentioned will for the most part present no accounting difficulties. Nice judgment may be required to satisfy the conditions of the fund, for all manner of limitations are frequently employed; but, important as strict adherence to these restrictions is, they do not affect the accounting methods as a rule.

Sometimes, however, such income is distributable by appropriation. In such cases the appropriations, if numerous or involved, should be charged against the income account and carried as appropriations are usually carried. Care should be exercised that any balance of such appropriations is carried forward, returned to the income account or otherwise properly handled as indicated by the terms of the fund.

After all charges, an unexpended balance sometimes remains. In some circumstances, as where more than ample funds have been provided for some specific purpose, an ever-increasing balance remains. It is important that the cash representing such balances be properly segregated and, where no immediate prospect of its disbursement is seen or where many such items exist at all times, demand deposit at interest seems to be required, the benefit, of course, accruing for purposes of the funds involved. In effect this adds a portion of the income temporarily at least to principal, an amount already more than adequate for current needs. In such circumstances when cash for general uses is short (and it usually is, and that properly in eleemosynary institutions) the objection is sometimes raised that it is not good business to borrow at six per centum while there is available money either idle or earning but four. The objection has a practical sound, but until permission from the courts or from the donors has been obtained such infringement constitutes a breach of trust and should never be employed even temporarily.

It is thus seen that, since the disposition of the income ultimately depends on the conditions of the fund providing it, at no point in the accounting should the restrictions under which the fund is created be overlooked. By accruing the income when it matures, but distributing it only when received, conditions of the fund are readily met, and in addition a more complete check of income, continuous and easily available, is recorded. No inflation of income occurs, but no income, whether received or not, is overlooked.