Flexibility in Financial Accounting Income Strategies and Earnings Management in the Netherlands

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Chapter 2

Overview of managers' use of financial accounting flexibility: a framework

2.1 Introduction

Noise and bias in financial statements arise among other things from managers' use of financial accounting flexibility. Thus, managers who exercise their accounting discretion to influence accounting data, influence the quality of financial statements. Although these accounting adjustments do not have to be seen as a negative signal, there is concern about the quality of financial statements and about managerial influence over accounting income. The framework provided in this chapter is a systematic attempt to understand financial accounting in general and the different aspects of managerial influence over accounting income specifically.

The focus is on accounting income because it measures the overall periodic performance of a firm under accrual accounting and is one of the most important numbers for stakeholders in the firm. No other figure in the financial statements receives for example more attention by the investment community than earnings. The relation between accounting income and security valuation is probably the most important relationship in security analysis, and its prominence is reflected in the attention given to price-earnings ratios (Beaver, 1989, p. 49). To emphasize the importance of accounting income, the former Chief Financial Officer of Aegon stated in this respect “In my career I have learned that stakeholders are only capable of evaluating one accounting number”.

The framework developed in this chapter is the basis for the discussion of the empirical study’s background provided in chapters 3, 4 and 5. The framework is based on an income

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17 A number of related concepts use earnings and a number of concepts use income. Since there is no logical difference, the terms earnings and income are used interchangeably in this study.
18 Accounting income is defined in this study as the difference between a firm’s revenues and expenses in a time period, including gains and losses from non-operating activities or extraordinary items.
strategy approach as introduced by Zmijewski and Hagerman (1981). This approach implies that management treats the firm’s set of accounting decisions as a single comprehensive decision.

Managerial influence over accounting income has many related concepts. In popular Anglo-Saxon literature the terminology creative accounting or window dressing is often used and usually implies unethical behavior. In academic literature the more neutral terminology income strategy, earnings management or income smoothing is often used. In order to understand the different aspects of managerial influence over accounting income the related concepts should be clear and the interactions between the concepts should be discussed. Paragraph 2.2 presents a framework for managerial influence over accounting income and defines and discusses the different concepts, together with related concepts and their interactions. The three basic aspects of the framework, the incentives to influence accounting income, the possibilities to influence accounting income and the constraints on managerial influence over accounting income are discussed only to a limited extent because an extensive discussion will be provided in chapters 3, 4 and 5. Managers may formulate a variety of income strategies based on their accounting objectives. Depending on five stereotype states of the firm’s financial situation, paragraph 2.3 provides a discussion of five general patterns in income strategies20 that may be distinguished.

2.2 A framework for managerial influence over accounting income

Financial accounting is the major means of organizing and summarizing information about business activities. This information is provided to decision-makers in the form of financial statements. To prepare these statements, firms analyze, record, quantify, accumulate, summarize, classify, report, and interpret economic events and their financial effects on the organization.

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20 As stated above the focus in this study is on accounting income. Other accounting strategies, such as solvency strategies, are not discussed in this study.
Simplified, the relationship between economic activities and financial statements can be shown by the following process:

Figure 2.1. Simplified overview of the financial accounting process.

The simplified overview of financial accounting however ignores important aspects of the financial statements as a summary of the economic consequences of a firm’s business activities. A more comprehensive overview will include the influence of the accounting environment, accounting system and accounting strategy on financial statements. The framework for managerial influence over accounting income discussed in this paragraph does explicitly take these influences into account. The framework for managerial influence over accounting is shown in figure 2.2. The different elements of the framework and the interactions are discussed in this paragraph.

*From business activities to financial situation*

The framework consists of two parts, the *business environment* and the *accounting environment*. The *business environment* consists of all factors and influences that do not directly relate to the *accounting strategy* and accounting decisions of the firm. A firm’s financial statements summarize the economic consequences of its *business activities*. The firm’s business activities are influenced by the *business strategy* and the *economic environment*. The *economic environment* includes all factors that are not controlled by the firm’s management. Examples are government regulations, competitor strategies and supplier strategies. The firm’s *business strategy* is the strategy that managers choose to achieve a competitive advantage by using the firm’s sources of advantage while taking into account the business risks. The firm’s *business activities* are its operating, investment and financing activities and the way these activities are organized in order to create value. The firm’s *business activities* result, given the firm’s *prior decisions* and accounting procedures, in a *financial situation*.

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21 The essential elements of the framework are italicized in this chapter only.
Figure 2.2. Framework for managerial influence over accounting income
The *financial situation* can be interpreted as the mechanical outcome of the financial accounting process in the absence of new events. New events will by definition lead to managerial accounting decisions\(^\text{22}\). The application of relevant accounting conventions may lead to different income and equity numbers. In the absence of *incentives* for managerial influence over *accounting income*, the mechanical outcome would have been reported. The mechanical outcome is nothing more than an aid, a conceptual variable, in thinking about managerial influence over *accounting income*. It is not what should have been reported, neither is it income without managerial bias since previous decisions may be biased and due to the reversal effects of these previous decisions the mechanical outcome may be biased as well.

**Incentives to influence accounting income**

*Incentives* to manage the mechanical outcome of the financial accounting process may come from different directions. *Incentives* are possible factors of influence on the *firm's income strategy*. Listed firms are by definition characterized by some separation of ownership and management. The first function of financial accounting is to report on the control and use of resources by management to whom they are accountable\(^\text{23}\). Managers are entrusted with the task of preparing the financial statements because management has private knowledge of their business activities. They are in the best position to summarize the business activities by estimating the future cash consequences of these activities. The second function of financial accounting is to provide information to *stakeholders*\(^\text{24}\). Accounting information in general and *accounting income* specifically is one of the sources of *information* concerning the firm. *Other sources of information* include credit ratings, analyst reports, press releases, the assets pledged as security for bank loans, the structure of management contracts and industry information. The content and timing of other information can effect the usefulness of accounting information to external parties.

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\(^{22}\) When a firm for example buys a brand from another firm, in addition to existing in house developed brands, management has to decide on the accounting treatment and the useful economic life of the brand. By deciding on the accounting treatment and the useful economic life the management by definition influences accounting income.

\(^{23}\) The stewardship function of financial accounting.

\(^{24}\) Additional functions of financial reporting are support for taxation purposes and dividend distribution.
Financial accounting plays two distinct informational roles. The first role is to facilitate decision-makers. Accruals reflect management’s expectations about future cash flows and are based on an information system potentially more comprehensive than past and current cash flows. Accruals can be said to involve some implicit and explicit prediction of the future, and accounting can convey information not contained in cash receipts and disbursements (Beaver, 1989, p.7). Managers may use accounting flexibility to provide better information about the future cash consequences of the firm’s business activities enabling the user to value the firm more correctly. From this perspective accounting income is one of many information signals on the state of the firm to the efficient capital market. This approach to managerial influence over accounting income is usually referred to as a signaling, informational or capital market perspective. The informational perspective will be discussed in chapter 3 as it is one of the incentives to exert influence over accounting income. The line from market reaction to incentives shows the informational perspective in figure 2.2.

The second informational role of financial accounting is to facilitate contracting between parties. The second incentive category stems from the economic consequences of accounting information because of existing and potential contracts, both explicit and implicit. The economic consequences of explicit contracts are shown in figure 2.2 by the line from accounting income to incentives. The line from implicit contracts to incentives shows the economic consequences of implicit contracts. From an efficient contracting perspective on economic consequences, managerial influence is aimed at minimizing the firm’s contract costs that arise from conflicts of interest between contracting parties. From an opportunistic contracting perspective on economic consequences, managers use their accounting discretion at the expense of other stakeholders. Chapter 3 provides a detailed discussion of the different incentives to exert managerial influence over accounting income.

Financial accounting flexibility
Managers who want to influence accounting income can choose from a large set of methods (Jiambalvo, 1996, p. 39). Some of the methods require real transactions and some are pure

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25 The function of financial reporting is more formal, embedded in the Civil Code and CAR Guidelines. The informational roles of financial accounting relates to the different settings where stakeholders use accounting information.
accounting decisions. Real transactions are operating, financing and investment transactions undertaken primarily to manage accounting income as opposed to directly increasing the firm’s value. The possibilities to influence accounting income through real transactions largely depend on the firm’s business activities. In financial accounting it has long been presumed that merely reporting cash flows is inadequate and that some form of accrual accounting is appropriate. Accrual accounting is viewed to be essential to proper financial accounting. However, it is apparent that the nature of the accrual process is ambiguous and not well defined. For virtually every major event that could affect the financial statements of a firm there exists a variety of alternative methods for matching costs and revenues (Beaver, 1989, p. 3). The choice among these alternative methods is an accounting decision. Pure accounting decisions have no direct effect on the firm’s cash flow. The possibilities to influence accounting income by pure accounting decisions depends on the business activities (including new events), the prior decisions and accounting procedures regarding these business activities and the flexibility of the accounting system.

*Flexibility* is one of the basic concepts in this study. The Collins English Dictionary (edition 1994) defines *flexibility*, metaphorically speaking, as the possibility to adapt or to vary. In terms of financial accounting, *flexibility* can be defined as the possibility to adapt financial information within the opportunities offered by the accounting standards. *Flexibility* thus relates to accounting standards in a specific country. Nobes and Parker (1998, p.40) state that despite requirements in the fourth EU directive there remains much more *flexibility* in the United Kingdom, Ireland and the Netherlands than in the rest of the EU. While the control by company law, tax law or accounting plan has been substantial in most European countries, there were traditionally no rules in company law, apart from a version of "fairness", in these countries. In this sense *flexibility* in accounting standards is the opposite of uniformity in accounting standards. The *flexibility* of the accounting standards in the Netherlands will be discussed in chapter 5. A related concept is financial accounting discretion. Where *flexibility* relates to the general latitude afforded to management, discretion relates to the specific latitude afforded to management. The Collins English Dictionary (edition 1994) defines discretion as freedom or authority to make judgments and to act as one sees fit. In terms of financial accounting, discretion can be defined as the firm’s specific possibilities to influence
Accounting income by real transactions and pure accounting decisions. Watts and Zimmerman (1986, p. 248) state that accounting income is the result of the portfolio of accounting procedures. Accounting income results from the application of relevant accounting conventions and these conventions could be applied to produce a range of different income figures (i.e. the accounting income range). Managerial discretion of a specific firm depends on the business activities, the prior decisions, the flexibility of the accounting system and specific accounting restrictions of its contract set. In financial accounting research the term discretion is often used when describing the construct used to detect earnings management. A number of widely used constructs test for earnings management by comparing discretionary accruals. The usual starting point for the measurement of discretionary accruals is total accruals. A particular model is then assumed for the process generating the non-discretionary component of total accruals. The difference between total accruals and the non-discretionary component is the discretionary component. The different constructs used to measure and detect managerial influence over accounting income are discussed in chapter 6.

The financial statements, and more specifically accounting income, provide stakeholders with information to make decisions about the allocation of their resources and facilitate contracting between parties. Economic consequences of financial accounting follow from both the decision making as well as the contracting role. Given this impact of financial statements on the stakeholders it is logical that stakeholders and financial accounting regulators perceive the accounting environment as important. The SEC in the US for example has the authority to issue accounting standards for firms under its jurisdiction. In the Netherlands employers', employees' organizations and the Royal Netherlands Institute of Registeraccountants (Royal NIVRA) are members of the Foundation for Annual Reporting and hence also members of the CAR. The influence of stakeholders and regulators on the flexibility of the accounting system is shown in figure 2.2 by the line from stakeholders and regulators to flexibility.

26 Total accruals can be defined as the difference between accounting income and cash flow from operations.
27 In Accounting Series Releases 150 this responsibility is delegated to the Financial Accounting Standards Board.
Constraints on managerial influence over accounting income

Managers can choose from a large set of methods to influence accounting income. Chapter 4 provides a discussion of the factors that may constrain managerial influence over accounting income given the possibilities and the firm’s incentives. Apart from real transactions, accounting income may be influenced through pure accounting decisions within Generally Accepted Accounting Principles (GAAP) or beyond GAAP. Different constraints may limit the use of pure accounting decisions within and beyond GAAP. Accounting income may be influenced to achieve different objectives related to the firm’s incentive. The objectives may be to provide better information, may be opportunistically motivated or motivated for efficiency reasons. Different constraints may limit accounting interventions for different objectives. The most important constraints are managers’ ethical standards, the firm’s governance structure, auditing, legal constraints, market forces and the probability of observation. The influence of stakeholders and regulators on the constraints is shown in figure 2.2 by the line from stakeholders and regulators to constraints.

Income strategy and earnings management

Income strategy is placed in a central position in the framework. The firm’s income strategy results from its general accounting strategy. The general accounting strategy, or accounting policy, defines accounting goals in terms of disclosure, liquidity, solvency and profitability and is a subset of the general business strategy. It is implicit in this definition that management considers the consequences of different strategies for the image that the financial statements project. The income strategy treats the firm’s discretion on the set of accounting items as a single comprehensive decision as opposed to discretion on individual accounting items. Income strategy can be defined as that part of the firm’s accounting strategy where management considers the economic consequences of different positions on the firm’s income range and where management defines their financial accounting goal in terms of accounting income. Depending on five stereotype states of the financial situation, five general patterns in income strategies may be distinguished (Hoogendoorn, 1996, pp. 97-99; Scott, 1997, p. 306). The five general patterns in income strategies will be discussed in the next paragraph. Once the income strategy is defined, management may purposeful intervene in the financial accounting process in order to implement the strategy.
Schipper (1989, p. 92) defines *earnings management* as a purposeful intervention in the financial accounting process, with the intent of obtaining some private gain. Private gains stem from the firm’s *incentives* and may relate to the firm or to its management. Thus *earnings management* can be interpreted as part of the implementation of the *income strategy*. *Earnings management* and accounting decisions on new events together implement the firm’s *income strategy*. Thus *income strategy* relates to managerial objectives and *earnings management* relates to the methods to achieve the objectives. *Earnings management* is restricted to management’s discretion within GAAP. Non-GAAP interventions in the financial accounting process are classified as earnings manipulation. Earnings manipulation is an economic crime and will normally not be considered an option. The differences between *earnings management* and earnings manipulation are discussed in more detail in chapter 4 and 5. In chapter 4 it is argued that several constraints have different effects on *earnings management* and earnings manipulation and in chapter 5 the distinction between *earnings management* and earnings manipulation is sharpened for the accounting environment in the Netherlands in general and this study more specifically.

2.3 General patterns in income strategies

The firm’s *income strategy* results from its general *accounting strategy* and defines the firm’s accounting goal in terms of *accounting income*. Managers may formulate a variety of income strategies based on their accounting objectives. As stated before, depending on five stereotype states of the *financial situation*, five general patterns in *income strategies* may be distinguished.

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28 In popular Anglo-Saxon literature the terminology creative accounting or window dressing is often used in this respect. Creative accounting can be defined as the transformation of financial accounting figures from what they actually are to what preparers desire by taking advantage of the existing rules and/or ignoring some or all of them. Window dressing may be defined as the process to arrange affairs so that the financial statements of concern give a misleading or unrepresentative impression of the financial position (Naser, 1993).

29 The constraints that may or will limit earnings manipulation will be discussed in chapter 4. The change of being caught for earnings manipulation largely depends on the institutional setting. In the Netherlands enforcement actions are relatively scarce but in the US for example there is ample evidence of actions is this respect (see for example Dechow et al. 1996).
<table>
<thead>
<tr>
<th>Financial Situation</th>
<th>Income Strategy (t)</th>
<th>Income Strategy (t+1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-time heavy loss</td>
<td>Maximize loss</td>
<td>Smooth income upwards</td>
</tr>
<tr>
<td>Sustained losses</td>
<td>Maximize loss or smooth upwards</td>
<td>Smooth income upwards</td>
</tr>
<tr>
<td>Performance around zero</td>
<td>Avoid loss</td>
<td>Smooth income upwards</td>
</tr>
<tr>
<td>Sufficient profitability</td>
<td>Smooth income upwards</td>
<td>Smooth income upwards</td>
</tr>
<tr>
<td>Very high profitability</td>
<td>Lower income now</td>
<td>Just above expectations</td>
</tr>
</tbody>
</table>

Table 2.1. Income strategies resulting from the firm’s financial situation. Adapted from Hoogendoorn (1995).

The states range from sustained heavy losses to sustained high levels of profitability. The resulting objectives are stated in terms of profitability and are displayed in table 2.1. The *financial situation* of a firm should be interpreted with care and in relation to other accounting periods and other firms in the same industry. Especially growth and stability are important aspects when comparing to other periods and firms. The general objectives resulting from the *financial situation* are only broad directions. The objectives in specific cases may be different as a result of firm specific *incentives*.

In general, a distinction should be made between recurring and non-recurring *incentives*. Non-recurring *incentives*, such as management buy-out offers, initial public offerings and executive changes induce a short term perspective that may cause the use of different interventions to influence *accounting income* because the reversal effect\(^{30}\) of the intervention on accounting income in subsequent periods may be of minor importance for the initiator(s). A CEO for example who will retire next year may use income increasing accounting interventions, such as a reduction in R&D spending, in order to maximize his compensation in the current period. By this intervention the current CEO borrows income from the future and his successor will pay because additional charges may be necessary to keep R&D at normal levels (see for example Dechow and Sloan, 1991). In case of recurring *incentives*, such as

\(^{30}\) The reversal of the effect on accounting income of different methods and interventions is important when management decides to choose among them to influence accounting income. In general a distinction can be made between methods with no reversal effect and methods with reversal effects in the short or long run. Reversal means that income increasing accounting interventions in the current period lead to a decrease in income in future periods and vice versa.
management compensation contracts and the general stakeholder relationship, the reversal effect on *accounting income* is important because next years *incentives* may be the same as this year's and *accounting income* may be of equal importance to the firm and its management. In the latter case the firm and its management will take account of the reversal effect of methods to influence *accounting income* on income in future years.

In case of a *(one-time)* heavy loss that cannot be avoided by altering the *business strategy* or by income maximizing accounting interventions, the firm's management may choose to maximize the loss in the current accounting period. These interventions may not have an additional influence on the *stakeholders' actions* because the loss was already significant. Of course there are limits to the loss one can present to the *stakeholders* without influencing their actions. Setting the objective to maximize the loss is referred to in the literature as “Big bath accounting” (Healy, 1985, p.86). The purpose of this strategy is to bank income for the future and thus create room to report (higher) profits in future periods. Creating accounting “reserves” for future periods always involves either a decrease in revenues and/or an increase in expenses (both of which decrease accounting income). In the Netherlands discretionary asset write-offs and reorganization provisions are likely to be used in this respect. It is likely that this *income strategy* will be succeeded by a loss minimizing strategy in future periods.

If the *losses occur in subsequent accounting periods* the loss maximizing strategy cannot be continued in order not to lose the confidence of the *stakeholders*. The most likely strategy is to maximize the loss in one period and set the accounting objective to minimize the losses in subsequent periods. However if a loss maximizing strategy in the current accounting period is not possible because of expected negative stakeholder actions, the objective is set to minimize the loss in this period and decrease the loss in subsequent periods.

In case of *accounting income* around zero it is important for the *stakeholders* opinion about the firm to show a (small) profit. Although the difference may be small in absolute terms, the perceived performance may differ a lot when the firm reports a loss instead of a (small) profit and thus may result in quite different stakeholder decisions. Since a small profit is more easily communicated to, for example, shareholders and banks, it is worthwhile to struggle across the threshold of zero earnings. Burgstahler and Dichev (1997) show that the frequencies of
accounting small losses are abnormally low, while the frequencies of small profits are abnormally high.

A sufficient profitable firm on the other hand, with no specific non-recurring incentives, is likely to smooth accounting income in order to show a stable growing profit over subsequent periods. A stable growth is especially appreciated in financial markets because it appears to reduce the risk of the investment as perceived by investors. In case of a sufficient profitable firm the objective to smooth accounting income normally follows from the firms business strategy. In years of a relatively high profitability the objective is to lower accounting income by creating accounting “reserves” for future periods or by repaying income borrowed in the past. In years of relative low profitability the objective is to smooth income upwards by borrowing income from the future or by using accounting “reserves” from the past. Setting the objective to smooth income over subsequent periods is referred to in the literature as “income smoothing”\(^{31}\). Ronen et al. (1977, p. 12) define income smoothing as “the dampening of fluctuations about some level of income that is currently considered to be normal for the firm”. The accrual accounting system itself may stimulate income smoothing because it matches economic benefit with economic effort. Income smoothing is the most likely strategy for a large sample of firms. Income smoothing can simplify managers’ relations with stakeholders because it is easy to communicate income growth over a number of periods. This makes it worthwhile to struggle across the threshold of increased earnings (see for example Degeorge et al., 1997). Burgstahler and Dichev (1997) find that firms with a consistent pattern of earnings increases command higher price-to-earnings multiples, after controlling for earnings levels. For many sufficient profitable firms increasing earnings per share is the most important accounting objective for the year.

Firms with an, in terms of risk and return, abnormally high profit face quite a different dilemma. In this case the downsides of a high profit may be greater than the positive effects resulting from it. Abnormally high profits may stimulate government agencies to intervene, labor unions to ask higher wages, competitors to enter the firm’s markets or may induce too high expectations from capital markets. In these cases the most likely objective will be to

\(^{31}\) See Ronan and Sadan (1981) for an extensive review on income smoothing.
lower the firm’s accounting income in the current and in subsequent periods to a position just above stakeholders expectations. When the firm’s income strategy is set to lower the firm’s profit for a longer period the firm is said to report conservatively (as opposed to “big bath accounting” in the first strategy described).

2.4 Summary and implications for this study

This chapter provided an overview of managers’ use of financial accounting flexibility. A framework for managerial influence over accounting income was developed in order to discuss the different concepts and their interactions. The framework serves as an aid in understanding the contemporary financial accounting process throughout this study.

The focus in the framework is on accounting income because it measures the overall periodic performance of a firm under accrual accounting and is one of the most important numbers for stakeholders of a firm. Accounting income as reported in the financial statements of a firm results first of all from the firm’s business activities. Taking into account the firm’s prior accounting decisions the business activities result in a financial situation of the firm. This financial situation can be interpreted as the mechanical outcome of the reporting process. In the absence of new events and incentives for managerial influence over accounting income, the mechanical outcome would have been reported. Incentives are possible factors of influence on the firm’s income strategy. Incentives may result from contracts, both explicit and implicit, as well as from the market reaction to accounting income. The incentives to influence accounting income will be discussed in depth in the next chapter.

The firm’s income strategy results from its general accounting strategy. The general accounting strategy, or accounting policy, defines accounting goals in terms of disclosure, liquidity, solvency and profitability and is a subset of the general business strategy. Income strategy can be defined as that part of the firm’s accounting strategy where management considers the economic consequences of different positions on the firm’s income range and where management defines their financial accounting goal in terms of accounting income. Once the income strategy is defined management may purposeful intervene in the financial
accounting process in order to implement the strategy. A purposeful intervention in the accounting process aimed at the implementation of the income strategy and with the intent of obtaining some private gain is referred to as earnings management.

When formulating the income strategy the firm’s management takes account of the possibilities to influence accounting income as well as the constraints on managerial influence over accounting income. The possibilities to influence accounting income depend on the business activities, the prior decisions regarding these business activities and the flexibility of the accounting system. Flexibility is one of the basic concepts in this study. In terms of financial accounting, flexibility was defined as the possibility to adapt financial information within the opportunities offered by the accounting standards. The flexibility of the accounting standards in the Netherlands will be discussed in chapter 5. The most important constraints on managerial influence over accounting income are manager’s ethical standards, the firm’s governance structure, auditing, legal constraints and the probability of observation. The constraints will be discussed in depth in chapter 4.

Finally, depending on five stereotype states of the financial situation, five general patterns in income strategies were distinguished and discussed in the previous paragraph. Again it is stated that the general objectives mentioned only give broad guidelines on possible income strategy objectives for individual firms. The objectives for specific firms may be different as a result of firm specific incentives. The next chapter provides a detailed discussion of the different incentives to exert influence over accounting income.