CHAPTER - II

APPROACHES TO MEASUREMENT OF EARNINGS
2.1 INTRODUCTION

Measurement of earnings is an important exercise to be performed by a business organisation. Earnings of a business organisation are used for its performance appraisal and the future direction of its business activities. It is also used as the basis of decision making by other interested parties viz; shareholders, creditors, customers, employees, government agencies etc. The usefulness of these decisions depends upon the quality of information about earnings. There are a number of approaches to the measurement of earnings, each leading to different figure of earnings. A user of earnings information should know the approach used in its measurement otherwise he will not be in a position to make right decision. Having regard to above facts, it is worthwhile to study different approaches to measurement of earnings and their relative merits and demerits. Therefore present chapter is devoted to the study of conceptual framework and different approaches to measurement of earnings.

2.2 MEANING AND SIGNIFICANCE OF EARNINGS

Earnings is an engine which drives enterprise. In an economic system of capitalism and free enterprise, earnings is the main force to attract capital for investment purposes. More appropriately, it diverts the capital into those fields of industry and trade where it will be most productive. Earnings, if not interrupted by human interference, functions like the power of gravity to hold the various planets of the universe of economics in their proper places.1

In the real physical world, measurement of earnings occupies a central position in accounting, as it enables the management to evaluate its past accomplishments and to plan its future activities.2 Generally speaking, earnings represents wealth increase and business success; the higher the earnings, the greater will be the success of business enterprise. Earnings has a substantial part to

2. AICPA Professional Standards; Para 1210.42
play in influencing the human behaviour. The following are some of the major areas where earning information is practically useful:

(i) **Earnings as a Measurement of Efficiency:** Financial reporting provides information about an enterprise's financial performance during a period. Thus, earnings is a measure to evaluate the quality of management's policy making, decision-making, and controlling activities.

(ii) **Earnings as a Guide to Future Predictions:** Earnings are the main plank on which the whole superstructure of management of earnings is based. It helps in evaluating the work of future investments while making investment decisions.

(iii) **Earnings as a Guide to Dividend and Retention Policy:** An entity-oriented management will attempt to pursue that policy which serves all the interests, that is through earning information, the company manages its earnings in such a way as to reward the owners adequately (for supplying the risk capital) in the form of dividends and to strengthen the financial health of the concern adequately through retention.

(iv) **Earnings as a Guide for Determining Tax Liability:** Earning figure determines the tax liability of a business enterprise. The taxation authorities generally accept the accounting concept of earnings as a basis of assessing the tax.

(v) **Earnings as a Guide to Creditworthiness and Other Economic Decisions:** Both current and future earnings are relevant to determine the concern's ability to repay loans and other liabilities at maturity. Many important decisions such as pricing policy, collective bargaining, governmental, social and economic rules and regulations etc are to be taken only if the earning information is known in advance.

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Thus, business is rather a purveyor of earnings to its owners than a claimant for the same.®

'Profits', 'Income or Earnings' are considered synonymous in accounting. The switch over from 'Profit and Loss Statement' to 'Income Statement' and then to the 'Earning Statement' is probably due to rising share of income tax in the profits of a concern and its growing effects on business policies and decisions. To earn the maximum net earnings is major objective of every concern or enterprise. The knowledge of past earnings is also essential to estimate the future earning potential. Thus the profitability measurements called 'Income Statement or Earning Statement' is a basis for variety of decisions relating to business. Detailed knowledge of past performance is essential to evaluate the investment worth, management success and the creditworthiness of an enterprise.®

According to G.D. Roy, the term 'income or earnings' be preferable for another reason as well, namely, that accounting income consists of both returns to the organisation and remuneration for the use of capital. In this way accounting earnings include much more than what economic earnings does which is the return for use of capital. Thus, on accounting concept of earnings both the terms 'profit' and 'income or earnings' convey the same idea.® An organization engaged in rendering services usually use the term 'earnings' to convey the idea of income.

Owners need some yardstick to measure the value of their enterprise, prospective shareholder's to make decision whether to invest in the company or not, management to evaluate its past performance and to plan their future activities, creditors to know the creditworthiness of an enterprise, and lastly labour and management a guide for negotiations. All these groups place their reliance upon the data disclosed in income or earning statement. Thus, the reasons for and the extent of progress of concern along with amount and trend of earnings are taken into consideration for rational decision-making.

6. Sinha G.; "The Concept of Income"; Studies in Accounting Theory; Edited by Mukerjee and Roy; P 111.
8. Sinha G.; "The Concept of Income"; Studies in Accounting Theory; Edited by Mukerjee and Roy; PP 94-98.
2.3 CAPITAL AND INCOME

Irving Fisher described capital as a stock of wealth at an instant of time.* Income as a flow of service through time. Capital, according to Fisher, is embodiment of future services, and income is enjoyment of these services over a specific period of time. If capital is the amount in the reservoir at any time, income is the amount flowing out of the reservoir during a period of time.10

When these terms are related to a business enterprise, capital is still the stock of wealth that can provide future services, income or earnings is thought of as the flow of wealth or services in excess of that necessary to maintain a constant capital. To preserve the invested capital is not the responsibility of accountant, but this is the responsibility of management, or possibly the decision of the owners or equity holders. The accountant's responsibility is to report the amounts that have been made available to the beneficiaries for their enjoyment or reinvestment and the change in capital of an enterprise. Thus in accounting the distinction between the flows to beneficiaries that represent amounts that can be enjoyed without impairing the future cash flows and those flows that represent reductions in wealth, is the distinction between income or earnings and a return of capital.11

2.4 COMPONENTS OF EARNINGS

Some generalizations can be made about components of earnings, the separate components will differ for different kinds of enterprises. The components of earnings usually consists of following items;

* Items relating to entity's ongoing major or central operations.
* Exchange transactions and other transfers between enterprise and other entities that are not its owners.

Items that are unusual or that occur frequently, but that do not qualify as "extraordinary items"

- Items that are estimated with little reliability.
- Results of transactions in investments in other enterprises.
- Unrealised changes in value of assets and liabilities (realised in accounting model).
- Items relating to payment or recovery of taxes.

The above list of components of earnings is not exhaustive. However, components of earnings can be divided into three categories:

2.4.1. Operating and Non-Operating Activities: Proponents of current operating performance concept of earnings frequently claim that operating items are generally of recurring nature and non-operating items are generally considered non-recurring and unpredictable. However, that is not always true. Many items may be operating in nature, but not necessarily recurring. For example, overtime payments during rush period, acquisition of raw materials under extremely fortunate circumstances. Similarly, some non-operating items may be recurring in nature. For example, annual floods in unavoidably hazardous areas.12

Under both measurement of earning concepts (current operating performance concept and all-inclusive concept), earnings from normal activities of enterprise generally identified separately from unusual items. The fact that an item otherwise typical is abnormal in amount or infrequent in occurrence does not qualify the items as unusual (known as extra ordinary and special items also). It remains a part of earnings from normal activities although separate disclosure of its nature and amount may be appropriate. An example of such an item would be write-off of a very large receivable from regular trade customer.13

Net earnings based on recurring (operating) items is useful to economic decision makers in predicting future earnings and cash flows. Recurring non-operating items are important as recurring operating items that are result of normal

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13. International Accounting Standards Committee; IAS 8; "Unusual and Prior Period Items and Changes in Accounting Policies"; 1978; Para 8.
business operations. Distinction between two operating and non-operating is useful for measuring management efficiency.

According to Accounting Standard 5 entitled "Prior Period and Extraordinary items and Changes in Accounting Policies" issued by Institute of Chartered Accountants of India (ICAI); there are two approaches to treatment of non-recurring items;

* Include them in reported net profit or loss with separate disclosure of individual amounts; and

* Show such items in statement of Profit and loss after determination of current net profit or loss.

In either case, objective is to indicate the effect of such items on current profit or loss. However, the extraordinary items are shown as a part of current net income.

2.4.2. Prior - Period Items: Financial Accounting Standard Board's Statement No. 16 states that with only special exceptions, all items of profit and loss recognised during an annual period shall be included in computation of annual earnings. The main exception is the correction of an error in financial statements of prior period.

Prior - period items are material charges or credits which arise in current period as a result of error or omissions in the preparation of financial statements of one or more prior periods. These (prior period) items are included in statement of profit and loss for current period but separate disclosure of all such items is made so that their impact on current profit or loss can be perceived.

2.4.3. Extraordinary Items: Accounting Principles Board Opinion No. 30 defined extraordinary item as including events and transactions that are both infrequent (or non-recurring) and unusual (or not related to normal operations). The nature and amount of each extraordinary item are separately disclosed so that users of financial statements can evaluate the relative significance of each items and their effect on operating results. Income and expenses arising from ordinary activities of the enterprise though abnormal in amount or infrequent in occurrence do not qualify as

14. AICPA Professional Standards; Para 2014.10 Special exceptions are made for prior interim periods of current year.

15. Financial Accounting Standard Board; Accounting Standard 5; "Prior Period and Extraordinary items and Changes in Accounting Policies"; Issued by Institute of Chartered Accountant of India (ICAI).
extraordinary. An example of such an item would be write-off of very large receivable from regular trade customer.16

2.5 CONCEPTS OF EARNING

Recognizing that the measurement of earnings has considerable conceptual and practical problems, several concepts of earnings at different levels are studied. These are earnings at structural level (i.e. transactions approach and activities approach to earnings measurement); and the accounting concept of earning, economic concept of earning, wealth maintenance concept of earning, economic value added concept of earning, and market value added concept of earning at interpretative level; and net earnings used as measures of efficiency of management at behavioural level (i.e. earnings as predictive device, managerial decision making and estimation theory); and measurement of earnings.

2.5.1 EARNINGS MEASUREMENT AT STRUCTURAL LEVEL

The concepts of earnings discussed in accounting literature at the structural level are as follows:

2.5.1.1. TRANSACTIONS APPROACH TO EARNING MEASUREMENT

It involves the recording of changes in asset and liability valuations only as these are the result of transactions. Transactions include both external and internal transactions. External transactions arise from dealing with outsiders and transfer of assets or liabilities to or from the firm. Internal transactions arise from the use of conversion of assets within the firm. Earnings are recognised when new market valuations replace the input (cost) valuations and when external transaction takes place. Internal transactions could lead to valuation changes, but only those that result from the use or conversion of assets are usually recognised and recorded. When conversion take place, value of old asset is usually transferred to new asset. Therefore, transactions approach lends itself readily to the concept of realisation at the time of sale or exchange and to cost connection in accounting.17

16. Financial Accounting Standard Board; Accounting Standard 5; Prior Period and Extraordinary items and Changes in Accounting Policies”; Issued by Institute of Chartered Accountant of India (ICAI).

17. Hendriksen Eldon S.; “Accounting Theory” ; Fourth Edition; Published by arrangement with Richard D. Irwin, Inc.; Homewood, Illinois; First Indian Print 1984; Khosla Publishing House; PP 139-140.
The main advantages of transaction approach to earning measurement are as follows:

- Application of different asset valuation methods is possible, as it provides information about assets and liabilities existing at the end of a period.
- Useful for the management, as net earnings of a business can be classified in terms of products, customers etc.
- Earnings data can be collected for operations within the firm and external factors separately.
- Various statements prepared under this approach, can be made to have linkage with each other. This enhances the fuller understanding and utility of data developed in this approach.

2.5.1.2. ACTIVITY-APPROACH TO EARNINGS MEASUREMENT

This approach focuses on the description of the activities of a firm rather than on the reporting of transactions (as in transactions approach). Activity earnings would be recorded during the planning, purchasing, production, and sales processes, as well as during the collection process.18

The main difference between transactions approach and activities approach is that, the former is based on reporting process that measures an external event or the transaction; and the latter is based on real world concept of activity or event in wider sense. Both approaches of earning measurement fail to achieve realistic earning measurements since both depend upon some structural relationships and underlying concepts and have no real world counterpart.

The main advantages of the activity approach to earnings measurement are as follows:

- It facilitates the measurement of several concepts of earning which can be used for different purposes.
- Managerial efficiency is better measured and understood through this approach.
- Accurate predictions are possible, because of different behavioural patterns and different types of activities.

2.5.2 EARNINGS MEASUREMENT AT INTERPRETATIVE LEVEL

The accounting concept of earning, economic concept of earning, the concept of capital maintenance, economic value added concept of earning and market value added concept of earning can be discussed in accounting literature at the interpretative level as follows:

2.5.2.1 ACCOUNTING CONCEPT OF EARNING

Traditionally in accounting, earnings was measured by asset valuation through the tool of balance sheet. But with the development of corporate from of organization, separating ownership and management, and thereby, shifting the emphasis from owner's viewpoint to the management's viewpoint; created the need for a more practical and logical solution to this problem. With this intention and alongwith the going concern concept, earnings began to be determined through 'income or earning statement' prepared in confirmity with generally accepted accounting principles.19

In accounting, the earnings will be the residual after charging all costs and expenses contracted, paid or provided for by the enterpriser or the management on his behalf for whatsoever function they may be. The charging of interest on capital of proprietor, or of rent for the premises owned by him or the salary payable to the proprietor will depend on the sweet will of proprietor himself. Expenses on insurance, bonus paid to staff and similar other items rank like ordinary expenses and are duly deducted to arrive at the net earnings figure.20

Accounting earnings is the difference between the realized revenues arising from the transactions of the period and the corresponding historical costs.21 Accounting concept of earnings is defined by following equation:

\[ E_a = R - E \]

where, \( E_a \) = Accounting earnings,
\( R \) = Revenues realized for the period
\( E \) = Expenses (corresponding historical costs)

Thus in accounting, earnings is taken as the residual by matching the revenue realized against the costs consumed. The basic function of the accountant is

to determine the revenue realized during a particular period (accounting period) and the costs involved in generating that revenue. The costs which are incurred but not consumed during the period are taken as deferred costs waiting for future conversion and delivery. This is true even with cash and other money assets. Thus, matching principle is applied to measure the expenses incurred in generating that revenue.\textsuperscript{22} In this matching process, the management accomplishments and efforts are brought into the centre and the earning power of the firm is, thereby, disclosed. In order to make the matching as objective and definite as possible, the accountant follows certain conventions and rules.\textsuperscript{23} Earnings so measured is simply "...the figure that results when the accountant has finished applying the procedures which he adopts."\textsuperscript{24}

**ACCOUNTING CONCEPTS & CONVENTIONS AND MEASUREMENT OF EARNINGS**

The measurement of accounting earnings is influenced by various accounting concepts and conventions. To understand the impact of these concepts and conventions on measurement of earnings, a brief description is given below:

(i) **Conservatism:** Under this approach, the earnings of one period may be shifted to another period in measurement of earnings. The understatement of the earnings is more justified when it is compared with the dangers of its overstatement. The measurement of stock at cost or market price whichever is less, the principle of amortization of intangible assets, not recognizing the increase in value of assets are few examples as applied to measurement of earnings. But it must not understate the earnings by providing excessive depreciation or excessive reserves etc.

(ii) **Consistency:** According to this concept, it is essential to follow the same basis from year to year in measurement of earnings as it facilitates comparison of performance from one period to another.


\textsuperscript{24} The Statement was made by J.B. Canning and reaffirmed by Stephen Gilman; "Accounting Concepts of Profit"; New York Ronald Press Company; 1945; P.610.
(iii) **Entity Concept:** According to this concept, the measurement of earnings is done from business point of view and not from owner's point of view, as the entity of proprietor is totally different from business. For example, interest on capital of owner is treated as an expense for measuring earnings of the business.

(iv) **The Accounting Period Concept:** In Accounting, earnings refer to the financial performance of the firm for a definite period. The commonly accepted accounting period is either the calendar year or natural business year to know the interim results of business and to correct these in time.

(v) **The Accrual Concept:** Revenues and costs are accrued that is, recognized as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

(vi) **Going Concern Concept:** The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor necessity of liquidation or of curtailing materially the scale of operations.

The fundamental accounting assumptions viz, Going Concern, Consistency, and Accrual are followed in financial statements as per Indian Accounting Standard and International Accounting Standard. Specific disclosure of these fundamental accounting assumptions is not required. If these fundamental accounting assumptions is not followed the fact have been disclosed.

**DEVELOPMENT OF ACCOUNTING CONCEPT OF EARNING**

In accounting, the earnings was originally measured by asset valuation through the tool of balance sheet; but now it is generally measured by matching revenue and costs consumed through the tool of income or earning statement. The shift of the method has been brought about by the development of business enterprise. Its progress may be summarized as follows:

(i) **Completely liquidated Venture:** Business income or earnings from each venture is measured by comparing the beginning cash investment with the ending cash net worth, as all assets are sold for cash.

25. Text of Accounting Standards issued by the Institute of Chartered Accountants of India; “Seminar on Accounting Auditing Standards”; Published by Sri Kamal Gupta, ICWAI’s Technical Director; 1990; P.A.5 - A.8.
Earnings = \( \Delta \text{Cash} + \text{Owner's withdrawls}. \)

There is no problem of asset valuation here and owner’s interest is the centre of attention.

(ii) Partially liquidated Venture: Part of the assets are still in hand; earnings from each venture is measured by comparing the beginning net worth with the ending net-worth.

Earnings = \( \Delta \text{Net Worth} + \text{Owner's withdrawls}. \)

Here, assets in hand will be valued at their potential market prices and owner's interest is the centre of attention.

(iii) Single Proprietorship: Here Business may be viewed as overlapping venture. When it is operated on trial basis, assets in hand will be valued at their potential market prices. When it is intended to be permanent, assets will be valued at unabsorbed original costs.

Earnings = \( \Delta \text{Proprietorship} + \text{Owner's withdrawls}. \)

With assets valued at unabsorbed original costs, the term 'net worth' is no longer literally proper; a new term 'proprietorship' is used. Here also, owner's interest is the centre of attention.

(iv) Large Publicly-Held Corporations: Because of the separation of ownership and management, the emphasis of accounting too shifted from owners viewpoint to management’s viewpoint. Here, the matching revenue realized against costs consumed through the tool of income or earning statement is thus, considered as logical and practical solution to the problem of accounting income or earning.

Earnings = \( \text{Revenue Realized} - \text{Costs consumed}. \)

Here, the business entity is the centre of attention. \(^{26}\)

MEASUREMENT OF ACCOUNTING INCOME OR EARNINGS

Every organization's main objective is to utilize its resources to the maximum possible extent and in such a way, so as to earn maximum earnings. The procedure for computing the accounting income or earnings is as follows:

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(i) DEFINING THE PARTICULAR ACCOUNTING PERIOD: Actually the earnings of a business can be determined precisely only on termination of business. But the life of business is uncertain and cannot be determined precisely. To know the operating results of business, it is desirable to adopt calendar year or natural business year as an accounting period for the preparation of financial statement.27

(ii) IDENTIFYING REVENUES OF THE ACCOUNTING PERIOD SELECTED: As the primary objective of a business concern is to earn an income, revenues are taken as the contributions or accomplishments and costs as the efforts or sacrifices. According to Accounting Terminology Bulletin No. 2 “revenue results from the sale of goods or the rendering of services.”28 Revenue is the price of goods sold and services rendered during a given accounting period. Earning of revenue increases owner’s equity. When a business renders services or sells merchandise to its customers, it usually receives cash or acquires an account receivable from the customer. The inflow of cash and receivable from customers increases the total assets of the company; on the other side liabilities do not change, but owner’s equity increases to match the increase in total assets. Thus, revenue is the gross increase in owner’s equity resulting from operation of the business. But not every increase in owner’s equity comes from revenue. The owner’s equity is also increased by the investment of assets in the business by the owner.29

WHEN TO RECORD REVENUE: THE REALIZATION PRINCIPLE

Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. It excludes amounts collected on behalf of third parties such as certain taxes. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash receivable or other considerations. Completed service contract method is a method of accounting which recognizes

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revenue in the earning statement only when rendering of services under a contract is completed or substantially completed. Proportionate completion method is a method of accounting which recognizes the revenue in earning statement proportionately with the degree of completion of service under a contract.™

The realization principle states that a business should record revenue at the time services are rendered to customers or goods sold are delivered to customers. In short revenue is recorded when it is earned, without regard to when cash is received. According to 1964 Concepts and Standard Research Committee of American Accounting Association, revenue is realised by receipt of a current (or liquid) asset capable of objective measurement in market transactions for services rendered. There are some exceptions to the General rule regarding measurement of accounting income or earnings with reference to revenue recognition discussed above. These are:

(a) **Recognition of Revenue on Completion of Production:** If revenue can objectively be measured earlier than the date of exchange between the buyer and seller, then revenue is recognized on this earlier date. In case of gold mining, revenue is recognised in the accounting period in which gold is mined rather than the period in which it is sold because gold has always a specified value and international market.

(b) **Recognition of Revenue before Completion of Production:** The sale basis of the revenue recognition is not followed in case of long term contracts. If revenue is recognised on completion of contract, it will mean postponement of revenue, and when revenue is recognised it will be a very heavy amount. Such practice may discourage the shareholders and will attract high rate of taxation.

Therefore, proportion of amount of revenue representing that part of the contract completed by the end of the year is treated as revenue before the completion of the contract.

(c) **Non-recognition of Revenue in case of Doubt:** In certain types of instalment selling or hire purchase, for example, a sizeable fraction of the customers default on their contracts and in view of uncertainty of realizing the full amount of sale, the seller may decide to recognize revenue, only as the instalment payments are received.

30. A Text of Accounting Standards (AS-9) issued by the Institute of Chartered Accountants of India on “Revenue Recognition”; Seminar of Accounting and Auditing Standards; ICWAI; New Delhi; 1990 P. A-55.
are received."

(iii) **Identifying Expenses Corresponding to Revenue Earned:** Expenses are the costs of the goods and services used up in the process of earning revenue. Thus, an expense is an expired cost and sometimes referred to as the “cost of doing business” i.e., expenses tell us how assets are decreased as a result of services performed by business.

Expenses cause the owner's equity to decrease, while the revenues earned increase the equity. For measurement of expenses due recognition is given in the period in which there is a:

* a direct identification or association with revenue of the period, as in case of merchandise delivered to customers;
* an indirect association with the revenue of the period as in case of office salaries or rent; or
* a measurable expiration of asset cost even though not associated with production or revenue for the current period, as in case of losses from floods or fire.

Four types of events need to be considered in distinguishing between amounts that are properly considered as expenses of a given accounting period and the expenditure or cash payments made in connection with those items. These are:

- Expenditures of this year are the expenses of this year.
- Expenditure made prior to this year, become expenses during the year, and appeared as assets in Balance Sheet at the beginning of year, such as opening stock, prepaid expenses and deferred charges, etc.
- Expenditure made this year, that will become expenses in future years; and shown as assets in Balance Sheet at the end of this year, such as purchase of assets and depreciation of assets become expenditure in future.

31. Opinions given by Expert Advisory Committee of Institute of Chartered Accountants of India on “Revenue Recognition”; The Chartered Accountant; March 1998; PP 40-45.
33. A Text of Accounting Standards (AS-9) issued by the Institute of Chartered Accountants of India on “Revenue Recognition”; Seminar of Accounting and Auditing Standards; ICWAI; New Delhi; 1990 P. A 55.
Expenses of this year, that will be paid in future year. These will appear as liabilities such as outstanding expenses in the Balance Sheet at the end of the year.

Thus, the accounting concept of earnings is based on historical cost concept. Income for accounting period considers only those costs which have become expenses i.e. those costs which have been applied against revenue. Those costs which have not yet expired or been utilized in connection with the realization of revenue are not the costs to be used in computing accounting income. Such costs are assets and appear on balance sheet. Prepaid expenses, inventories and plant thus represent examples of deferred unallocated costs.34

(iv) Matching Principle: Business earnings is the outcome of the excess of revenue over related expired cost and the result of other gains to the enterprise from sale, exchanges or other conversion of assets. It involves matching of costs with revenue. Matching Principle requires that revenues which are recognized through the application of realization principle are then related to relevant and appropriate historical costs. The cost elements regarded as having expired service potential are allocated or matched against relevant revenues. The remaining elements of costs which are regarded as continuing to have future service potential are carried forward in traditional balance sheet and are termed as assets. Such assets measurements, together with corresponding measurements of entity's monetary resources, and after deduction of its various liabilities, give rise to its residual equity or accounting income. In short, Matching process is to divide the stream of costs between the present and future costs, assigned to present revenue become expenses or costs consumed and appear in the income or earning statement. Costs deferred for future revenue are taken as assets and appear in balance sheet.35

35. Liao S. Shu; "The Matching Concept and Cost Allocation"; Accounting and Business Research; Summer 1979; P 228-236.
ARGUMENTS IN FAVOUR OF ACCOUNTING CONCEPT OF EARNINGS

Accounting concept of earnings has the benefit of sound, factual and objective transaction base. Based on historical cost concept, accounting earning is measured and reported objectively, hence can be used for comparisons. Accounting concept is based on entity concept with a view to exhibit the current operating performance of the enterprise to the concerned parties i.e. to shareholders regarding use of resources etc. Thus, Accounting concept of earnings is very useful in judging past performance and decisions of the management.36

ARGUMENTS AGAINST ACCOUNTING CONCEPT OF EARNINGS

The traditional accounting concept of earnings is based upon the historical cost principle and conventions which may be severally criticized e.g. lack of useful contemporary valuations in times of price level changes; inconsistencies in the measurement of periodic earnings of different enterprises and even between different years for the same enterprise due to generally accepted accounting principles. Thus, accounting earnings could be misleading, misunderstood and irrelevant to users for making investment decisions.37

The accounting concept of earnings fails to recognise unrealised gains in the value of assets with the result that useful information is not disclosed to external financial users. Rather what is disclosed, is a heterogeneous conglomeration of information, quite distant from the realistic position.38

The earnings concept can be judged from practicability and usefulness point of view. Accounting concept of earnings, judged from 'practicability' point of view, is quite satisfactory, as it is based on the principle of objectivity. But from

'usefulness' point of view, it is highly objectionable, though it depends upon realisation principle in which recognition of those items is done, which are realised and other's are rejected, which shows radically different earnings. Too much flexibility and subjectivity involved in measuring accounting earnings, makes the comparisons of earnings between different time periods difficult.

2.5.2.1.1 BASIS OF MEASUREMENT OF EARNINGS

All concepts of earning measurement focus on measurement of net earnings which is the difference between gains and losses, or incomes and expenses, or revenues and costs. Net earnings may be measured either on cash basis or accrual basis.

The accrual basis recognizes the impact of transactions on financial statements in the periods when revenues and expenses occur instead of when cash is received or disbursed. That is, revenue is recorded as it is earned and expenses are recorded as they are incurred - not necessarily when cash changes hands. For example revenue is recognised when sales are made on credit, expenses are recorded as efforts are expended or services are used to obtain the revenue etc. The accrual basis is principal conceptual framework for relating accomplishment (revenues) with efforts (expenses). More than ninety five percent of all business is conducted on credit basis; cash receipts and disbursements are not critical transactions as far as the recognition of revenue and expense is concerned. Thus, accrual basis evolved in response to a desire for a more complete, and therefore more accurate report of financial impact of various events.

Under cash basis, revenue and expense recognition would depend solely on the timing of various cash receipts and disbursements. The difference between cash received and cash paid during a particular accounting period is termed as net earnings of that period. The major deficiency of cash basis of accounting is that it is incomplete. It fails to match efforts and accomplishments (expenses and revenues) in a manner that properly measures economic performance and financial position.

The accrual basis of accounting includes considerations relating to deferrals, allocations, depreciation and amortization, as this basis of accounting attempts to...
record financial effects of transactions, events and circumstances of enterprise in the period in which cash is received or paid by enterprise. The major difference between accrual accounting and accounting on cash receipts and outlays, is in timing of recognition of revenues, expenses, gains and losses. Cash receipts in particular period may largely reflect the effects of activities of enterprise in earlier periods, while many of cash outlays may relate to activities and efforts expected in future periods. Thus an account showing cash receipts and cash outlays of an enterprise for short period cannot indicate how much of cash received is

- return of investment, and
- return on investment

and thus cannot indicate whether or to what extent, an enterprise is successful or unsuccessful.40

2.5.2.2. ECONOMIC CONCEPT OF EARNING

The economic concept of earning is based on Hick's concept of earning defined as "the amount which a man can consume during a period and still remain as well off at the end of the period as he was at the beginning."41 Hicks presented his concept of "Welloffness" as the basis for a rough approximation of personal earnings. According to him, earnings are maximum which can be consumed by a person in a defined period without impairing his "welloffness" as it existed at the beginning of the period. Welloffness is equivalent to wealth or capital. Hick's concept of earning was subsequently adopted by Alexander, who defines earning as the amount the company can distribute to the shareholders and be as well off at the end of the year as it was at the beginning.42

In economics, the earnings would mean net increase in the wealth, viz cash flow plus change in value of firm's assets. This definition incorporates the time dimension and therefore implies discounted value (present value) of the stream of

40. Sikidar Sujit; "Accounting Theory; Policy and Practice"; Horizon Publishers; 1998; PP 159-160.
benefits. Economic earning is measured in real terms and results from changes in the value of assets rather than from the matching of revenue and expenses. Thus, it is the result of Balance Sheet valuation as we compare the aggregate value of the enterprise both at the beginning and at the end of the period. If the firm moves to a better position or there is an increase in their capitalized values, the result is an earnings, which means there is an increase in real net worth of the firm; otherwise the result is a loss. In short, we can say that economic earnings leans heavily on expectations and judgement. It is therefore, what Hendriksen (1972) has termed capital maintenance concept of earning, since 'welloffness' may be interpreted as maintaining capital intact. It is measured by comparing the value of the company at two points in time in terms of the present value of expected future net receipts at each of those two points.

DEVELOPMENT OF ECONOMIC CONCEPT OF EARNING

The development of the economic concepts of business income or earnings may be summarized as follows:

(i) **Mercantilists:** Earnings was the balance of profit on the merchant’s books at the end of the year.

(ii) **Physiocrats:** Only 'net product' of the agricultural entrepreneur was true income. The term 'net product' implied that income was something available for consumption after paying rent and replacing all 'original expenses' and annual expenses.

44. Haig M. Robert; "The Concept of Income, Economic and Legal Aspects"; The Federal Income Tax; Edited by R.M. Haig; New York; Columbia University Press; 1921; PP6-7.
46. Fisher Irving; "Income"; Encyclopaedia of Social Sciences; No. VII: June, 1931; P 625.
47. Sprigel W. Henry (f.d.); "The Development of Economic Thought: General Economists' in Perspective; New York; John Wiley & Sons; 1952; PP 83-86.
(iii) **Adam Smith**: Gross revenue was the total annual product of kind and labour and net revenue was what remained after deducting the expenses for maintaining, first, fixed and second circulating capital.48

(iv) **Alfred Marshall**: "..... net income is found by deducting from his gross income the outgoings that belong to its production".49

(v) **Robert M. Haig**: "Income is the money value of the net accretion to one's economic power between two points of time."50

(vi) **A.C. Pigou**: In connection with the definition of national income Pigou insists that physical capital must be maintained intact.51

(vii) **F.A. Von Hayek**: Hayek believes that the purpose of maintaining capital intact is to maintain the income stream constant.52

(viii) **F.W. Paish**: Each person may have some preferred combination of capital value and income stream which he likes to maintain. As long as he is indifferent between the new and old combinations of capital value and income stream, his capital is maintained intact.53

(ix) **J.R. Hicks**: Hicks defines the man's income as "the maximum value which he can consume during a week and still expect to be as well off at the end of the week as he was at beginning". Being "aswelloff" economically interpreted as "maintaining capital intact in terms of the discounted value of the expected future net receipts".54


53. Paish F.W; "Capital, Value and Income"; Economica; VII; November 1940; PP 416-418.

LIMITATIONS OF ECONOMIC CONCEPT OF EARNINGS

Economic concept of earnings has several difficulties. In fact, there is no agreement as to the meaning of "welloffness" that occurs in specific time periods. Also, this term is not well defined in terms of operational aspects of an enterprise. The greatest problem lies in measuring net assets at the beginning and end of the period, for the difference represents earnings.55

Secondly, choice of discount factor matters a lot. The net present value concept requires that the discount rate selected for reducing future cash flows to their present value should reflect accurately the time value of money. If interest rates are going to fluctuate during the time period considered for using the asset, it follows that the correct present value of asset will be distorted simply because the correct discount rate has not been applied. Thus, variations in discount factors produces entirely different measures of earning, which will not be helpful in taking decisions.56

Thirdly, an individual attempts to maintain his welloffness at a constant level and maximise it by investing capital in activities which will yield increasing benefits over times.

Therefore in forecasting benefits for discounting purposes, a significant problem would be the possible element of growth to incorporate, assuming growth of capital to be one of the objectives of person concerned. The choice of such a growth factor further increases the subjectiveness of economic earning.57

Fourthly, accurate predictions about timing of receipt of future cash flows are difficult to make. Different realisation times produce different measures of capital, and thus different income figures. Inaccuracies in forecasting of realisation times will therefore, produce corresponding inaccuracies in earning measures.58

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55. Hendriksen Eldon S.; Accounting Theory; Fourth Edition; Khosla Publishing House; First Indian Print 1984; PP 143-144.
57. Lee T.A; "Income and Value Measurement"; London; Thomas Nelson & Sons Ltd; 1974; P.41.
Fifthly, because of future cash flows and discount rate cannot be determined with certainty, Edwards and Bell (1961) call economic earning as “subjective earning” and dismiss the concept on the grounds that it cannot be satisfactorily applied on an operational basis.\(^{59}\)

Economic concept of earning is based on proprietary concept - an all-inclusive concept as it takes into consideration all items (even though not transacted) which affects the proprietor’s capital during a period. Moreover the economic earning is measured by valuations, based on expectations and judgements as it takes into consideration the unrealised gains based on expectations. The economic concept of earning is not objective and definite; but the concept of ‘welloffness’ is really a matter of individual’s personal preferences. For all these reasons, the economic concept of earning has little applicability to the problem of financial reporting.

**RECONCILIATION BETWEEN THE ACCOUNTING AND ECONOMIC CONCEPTS OF EARNING**

The relationship between these two concepts of earning have been brought about by many theoreticians. According to David Solomons (1961), the following adjustments are made in the accounting concept of earning, to derive economic earnings;

\[
\text{Accounting Earning} + \text{Unrealised tangible asset changes during the period.}
- \text{Realized tangible asset changes which occurred in prior periods.}
+ \text{Changes in the value of intangible assets}
= \text{Economic Earning}
\]

The changes in the value of intangible assets do not refer to the conventional intangible assets found in the balance sheet but to a concept called subjective goodwill arising from the use of expectations in the computation of economic earning.\(^{60}\)

Edwards and Bell also attempted a reconciliation between the two concepts. They introduced the concept of business income, based on replacement cost valuation and recognise only gains accruing during the period. Business income

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comprises: (i) the current operating profit (X) which is the difference between realised revenue and the corresponding replacement cost, current operating profit is defined as "excess over a period of current value of output sold over the current cost of related inputs"; (ii) the realised and accrued holding gains of the period (Y); and (iii) the unrealised holding gains and losses accruing in the period (W). A holding gain arises whenever the current market value of an asset exceeds its historical cost.

Thus, Business income (Bi) may be expressed as:

$$\text{Bi} = X + Y + W$$

Where, Bi stands for Business income;

X is Current Operating Profit;

Y is Realised and accrued holding gains of the period; and

W is Unrealised holding gains and losses accruing in the period.

The Accounting principles followed for determining the business income are as follows;

(i) When price changes increase the value of an asset, realisable cost savings should be recorded. These form the capital gains element of business income. Similarly, when price changes decrease the value of an asset, realisable capital losses should be recorded.

(ii) When an asset or asset service is used in production, its current cost should be deducted from current value of output to calculate operating profit.

(iii) The difference between current cost and historic cost of assets or asset services used in production also marks the conversion of what was a realisable gain to a realised gain. This amount should be transferred from unrealised cost savings account to realise cost savings account.61

When these principles are applied in the accounts, the fundamental accounting equation is modified from historical cost basis to current cost basis.

Simply stated,

Accounting Income (I)

- Holding gains realized in current period but accruing in previous periods (Z)
+ Holding gains accruing but not realized in current period (W)
= Business Income (I)

Edwards and Bell discarded the concept of Economic earning as "essentially short-run in nature". Instead they introduced Business Income comparable long-run concept. Business income is contrasted with accounting income or earning in the following manner;

**Business Income == Current Operating Income + Realizable Capital Gains.**

Where, Realizable capital gains, are the result of changes in expectations, and Current operating income is the difference between current value of output and current value of input.

**Accounting Income == Accounting Operating Income + Realized Capital Gains.**

Where, Accounting operating income is the difference between Revenues & Expenses, and Realized capital gains are the selling prices of surplus assets less their book values.
Neither business income nor accounting concept of earnings makes any allowance for changes in general price level, both real gains resulting from changes in relative prices and fictitious gains resulting from the effects of a rise in general price level being regarded as income or earning.42

COMPARISON BETWEEN ACCOUNTING AND ECONOMIC CONCEPT OF EARNINGS

Accounting concept of earnings, an expost measure (that is measured after the event) modifies and influences the human behaviour. While economic concept of earnings, a micro-economic concept of earnings rationalises on human behaviour (that is maximising his present consumption without impairing his future consumption by eroding his economic capital).

The accounting concept of earnings based on historical cost conventions and transactions, recognises economic benefit flows only when they have been realized. On the other hand, the economic concept of earnings based on valuation of all anticipated future benefits, recognises the economic benefit flows well before they are realized. Because, economic earnings are measured by valuation based on expectations and judgment and accounting earnings are measured by realization principle.

Accounting concept of earnings and economic concept of earnings basically differ in terms of the measurement. As Boulding observes;

"Accountants measure capital in terms of actualities, as the primary by-product of the accounting income measurement process; and the economist in terms of potentialities, in order to measure economic income".

Thus, accountant basically adopts a totally backward-looking approach and ignore potential capital value changes. The economist, on the other hand, is forward-looking in his model and bases his capital value on future events.63

The two concepts of earning appears to be poles apart in concept and measurement. The accountants find the economic model almost impossible to put into practice in financial reporting, despite its eminently desirable theoretical qualities and the economists fail to find much relevance in the accounting model as a guide to prudent personal conduct.64

Inspite of above differences in the concept and measurement of accounting earnings and economic earnings, there exists some similarities between two. These are;

64. Lee T.A; "Income and Value Measurement" ; Thomas Nelson and Sons Limited, London; 1974; P.64.
Both the concepts of earning (Accounting and Economic) as measures of better offness, would be readily determinable and would be identical. With such knowledge, earnings for a period would be the change in present value of future cash flows, discounted at an appropriate rate for the cost of money. Under current cost accounting, reported earnings equal the economic earnings in perfectly competitive equilibrium market system. During periods of adjustment to temporary disequilibrium conditions, the current cost earnings may or may not approximate economic earnings. When asset market prices move in the directions opposite to expected cash flows, there tends to be a difference between both the concepts of earnings as the assets are overvalued. On the other hand, when assets market price move in line with expected cash flows, the current cost earnings tends to approximate the economic earnings quite well.65

"Accounting income should measure operations and represent the period-by-period progress of an enterprise towards its overall goals. Accounting measurement of earnings should recognize the notion of economic betteroffness, but should be directed specially to the enterprise' success in using cash to generate maximum cash".

The above quoted relationship between accounting concept of earnings and economic concept of earnings has been commented by Trueblood Committee Report.66

2.5.2.3 CONCEPT OF CAPITAL MAINTENANCE

Maintenance of capital by an enterprise is very much essential to survive. If distribution of earnings is more than it can afford, the capital of the enterprise comes down. Every enterprise therefore endeavour to ensure that its capital is not eroded. According to Forker, the capital maintenance concept is viewed merely as a neutral benchmark to be used in determining the surplus which accrues to shareholders as income and implies nothing which ought to be interpreted as suggesting normative behaviour for the management of the enterprise.67

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65. Revsin L; "On the Correspondence Between Replacement Cost Income and Economic Income"; The Accounting Review; July, 1970;
The following structure will depict the different concepts of capital maintenance:

**CONCEPT OF CAPITAL MAINTENANCE**

- **Financial Concept**
  - Money Maintenance Concept
  - General Purchasing Power Money Maintenance Concept

- **Physical Concept**
  - Productive Capacity Maintenance Concept
  - General Purchasing Power Productive Capacity Maintenance Concept

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1) **FINANCIAL CONCEPT**

Earning is equal to the change in the money amount of net assets. Under money maintenance concept, the financial capital is measured in the units of money.

Under general purchasing power money maintenance concept, financial capital can be said to be maintained only if capital at the end of a period has same general purchasing power as capital at the beginning of the period.

2) **PHYSICAL CONCEPT**

Under this Concept, earnings takes place only if physical productive capacity of an enterprise at the end of a period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from owners during the period.

The physical concept under general purchasing power productive capacity maintenance implies the maintenances of physical productive capacity of the enterprise measured in units under same purchasing power. Physical capital maintenance concept is useful as a basis to assess whether an enterprise has maintained, increased or decreased its operating capability; useful in understanding performance of enterprise; predicting future; cash flows; useful to understand past changes; and to predict future changes in the volume of activity.68

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Financial Accounting Standards Board (FASB) has attempted to bring earnings measurement and capital maintenance concept together in following terms:

<table>
<thead>
<tr>
<th>EARNING STATEMENT APPROACH</th>
<th>ASSET / LIABILITY APPROACH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Historical Cost</td>
<td>Financial capital measured in units of money.</td>
</tr>
<tr>
<td>Constant Dollar</td>
<td>Financial capital measured in units of same purchasing power.</td>
</tr>
<tr>
<td>Current Cost</td>
<td>Physical Capital measured in units of money.</td>
</tr>
<tr>
<td>Current Cost / Constant Dollar</td>
<td>Physical Capital measured in units of same purchasing power.</td>
</tr>
</tbody>
</table>

There is no agreement regarding the usefulness of their concepts among experts. Thus the issue of choice between these concepts remains unresolved.69

DIFFERENCE BETWEEN TWO CAPITAL MAINTENANCE CONCEPTS

During price level changes the effects on assets and liabilities under two concepts can be seen as under. Under financial capital concept, if the effects of those price changes are recognized, they are conceptually holding gains and losses (though they are commonly reported under other names) and are included in return on capital. Under physical concept, these changes would be recognised but conceptually would be capital maintenance adjustments that would be included directly in equity and not included in return on capital.70

Efforts to have a single concept of earnings were given up by American Accounting Association (AAA) committee to prepare a Statement of Basic Accounting Theory (ASOBAT) 1966, as no single concept of earnings is suitable to different categories of users.

The greatest difficulty with this concept of wealth maintenance is in the measurement of net assets at the beginning and end of period. Several methods of valuation may be suggested (a) capitalization of expected future, net stream of cash or services to be received over the life of firm (b) the aggregation of selling prices of several assets of the firm less summation of liabilities, (c) valuation of firm on the

70. Financial Accounting Standards Board; Statement of Financial Accounting Concept No. 5; P.17; Para 48.
basis of current stock market prices applied to the total stock outstanding, and (d) valuation of the firm by using input values (either historical or current cost) for non-monetary assets and adding the present cash value of monetary assets and subtracting liabilities.\footnote{71}

**MEASUREMENT OF NET ASSETS AND DETERMINATION OF EARNINGS**

The capital maintenance concept of earnings brought the accounting concept of earnings and economic concept of earnings quite close to each other. The accounting concept of earnings, is defined as the difference between net assets of firm at the end and beginning of a particular period. This involves the measurement of net assets for determination of earnings. Several methods for measuring the net assets are discussed below:

**A) Capitalisation Method**

Here capitalized value is computed, which can be defined as "the present discounted value of the expected cash distributions to shareholders by the firm during the remaining life of the enterprise, including the final amount expected to be paid at liquidation." Three factors must be considered in computing capitalized value. These are (I) the expected amount of net cash distributions each year, (ii) remaining number of years, and (iii) appropriate discount factor. This relationship can be expressed by following formula:

\[
P = R_1 (1+i)^1 + R_2 (1+i)^2 + \ldots + R_n (1+i)^n
\]

or

\[
P = \sum_{t=1}^{n} \frac{R_t}{(1+i)^t}
\]

Where, \( P \) = Present value (or capitalized value) at time zero.
\( R_t \) = Expected net cash flow distribution in \( t \) period
\( i \) = Appropriate discount factor.
\( n \) = Number of years of expected life.

Thus, Earnings for the first year can be computed as follows:

\[
E_1 = P_1 - P_0 + R_1
\]

Where, $F_1 = \text{Earnings for the first year.}$

and value of $P_1$ is computed by using following formulae.

$$ P_1 = \sum_{t=2}^{T} \frac{R_t}{(1+i)^t} $$

(3.4)

In this manner, the earnings for subsequent years may also be calculated.\textsuperscript{72}

Under conditions of certainty, the economic earnings provide an ideal concept for financial reporting purposes. The value of firm's future net receipts may be capitalized, thereby providing the investor with a basis for decision-making. It means, if initial earnings were distributed to stockholders and remaining amount of cash reinvested in the project that will yield, then the earnings and capitalized value of the firm would remain constant in future.

The presence of uncertainty, which is the general rule, precludes the use of economic earnings because of its essentially subjective nature. Most authors define appropriate rate as the subjective required rate for investments of equal risk or the target rate of return.\textsuperscript{73}

Under capitalization concept future cash flows and discount rates cannot be estimated with certainty and the measurement of capital is based on expectations regarding future cash flows or on market prices as substitutes for subjective expectations.

In short, we can say capitalization concept too suffers because of the following reasons; (a) Time factor and expected cash flows are considered for measuring earnings while all other economic events and activities are ignored; (b) Expectations regarding future cash flows cannot be converted into single values; (c) Value of firm is determined by discounting all expected cash indefinitely into future, many of which have no relationship to current or past activity; (d) Expectations are dependent upon optimism and pessimism state existing at that time, in the world of uncertainty. There are a number of alternatives to capitalization concept of earning measurement. There are discussed below;

\textsuperscript{72} Hendriksen Eldon S.; "Accounting Theory"; Fourth Edition; Published by arrangement with Richard D. Irwin, Inc.; Homewood, Illinois; First Indian Print 1984; Khosla Publishing House; PP 144-145.

(i) **Market Valuation of firm**: The value of firm is determined by multiplying the number of shares outstanding by market price of the stock as determined by exchange markets. This method is different from capitalization concept of earning measurement because opportunity rate of return and adjustment for risk in market may be different then accountant's subjective discount rate. This method has many disadvantages associated with capitalization process except verifiability.74

(ii) **Current Cash Equivalent**: Firm's capital is determined by subtracting the sum of money equivalent to the liabilities from sum of money equivalent to all assets. Current cash equivalent can be defined as the market selling price or realizable price of assets held by the firm.75 Income for period can be determined by computing net assets of firm at the end of period and subtracting the net assets computed in similar fashion at the beginning of period and adjusting for capital transactions.76 This method of valuation of firm is more objective and verifiable than capitalized value of firm because these prices depend upon expectations of others outside the firm. It provides better basis for judging the alternative open to management. But it has limited basis for prediction of future changes because it does not disclose the nature of changes arising in prior period. This method also suffers, because of lack of ready market for many of assets owned by the firm.

(iii) **Historical Input Prices**: Firm's earning is determined by the use of input prices either in terms of historical costs or current costs (less depreciation where necessary). It is not subject to real-world interpretation because of the reliance on depreciation allocations and concept of realization. The resulted earnings computation is based on structural rules rather than reality. As net earnings will be the result of normal operations and part thereof will arise from abnormal transactions and from capital gains resulting from unexpected value changes.

74. Hendriksen Eldon S.; "Accounting Theory"; Fourth Edition; Published by arrangement with Richard D. Irwin, Inc.; Homewood, Illinois; First Indian Print 1984; Khosla Publishing House; PP. 149-150.


76. Ibid; PP 112-114.
(iv) **Current Input Prices:** Firm’s earning is determined in the same way considering historical costs if inputs as expressed in terms of current values. But earnings include holding gains and losses arising from price changes—whether or not these holding gains and losses have been realized through sale or exchange. That is, earnings will include gains and losses from holding of assets as well as normal operating profit.\(^7\)

**B) CURRENT ENTRY PRICE OR REPLACEMENT COST METHOD**

The current entry price is the “amount of cash or other consideration that would be required to obtain same asset or its equivalent.”\(^6\) It means, entry price is estimated when an asset is to be replaced. In case of existing asset, either replacement cost or reproduction costs are estimated. In case of new asset, replacement cost is considered. Several methods are advocated for measurement of current entry price. These are (a) quoted market prices, (b) purchase price of substitute assets, (c) specific price indices, and (d) management estimates or appraisals.

Holding gains and losses are the consequence of valuation of assets and liabilities at current entry price. They may be divided into:

* realized holding gains and losses arising from items sold or liabilities discharged, and
* non-realized holding gains and losses arising from items still held or liabilities owed at the time of reporting period.

They may be classified as earnings if financial concept of capital maintenance is adopted. The segregation of current value income into current operating profit and holding gains and losses have advantages of evaluating the past performance of managers, in making business decisions, in analysing and comparing inter period and inter company performance gains. Besides it represents abandonment of realization and conservatism principles so that accrued holding gains and losses are also recognised.\(^7\)

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77. American Institute of Certified Public Accountants; AICPA Professional Standards; Para 1072-100.


C) CURRENT EXIT PRICE OR NET REALIZABLE METHOD

"The amount of cash for which assets might be sold or liabilities refinanced is known as current exist price, on the condition that the selling price should be under conditions of orderly rather than forced liquidation and at the time of measurement. Here, all assets and liabilities are revalued at their net realizable values. The net realizable values correspond to the quoted sales price on demand market, while current entry prices correspond to quoted sales price on supply market."

The realization principle is completely abandoned for recognition of revenues under this approach, i.e. the operating profit and holding gains are segregated. But system is useful as it provides relevant information to evaluate the financial adaptability and liquidity of firm and to make accurate performance appraisal of the management of the company.

COMBINED APPROACH FOR VALUATION OF ASSETS

Sprouse and Moonitz states that where assets are to be replaced, use current entry price (replacement cost) and where they are not to be replaced use current exit price (net realisable value).""

The Trueblood Committee also agree with above view. They have stated:

"Current replacement cost may be particularly appropriate when significant price changes or technological developments have occurred since the assets were acquired..... Exit value may be an appropriate substitute for measuring the potential benefit or sacrifice of assets and liabilities expected to be sold or discharged in a relatively short time.""

Financial Accounting Standard Board (FASB), SFAC No. 6 defined assets as "Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" and liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities."

81. Sprouse and Moonitz; "Accounting Research Study"; No. 3; American Institute of Certified Public Accountants; 1962; P.244.
82. Trueblood Committee Report; American Institute of Certified Public Accountants; New York; PP 41-43.
All classes of Assets and liabilities currently reported in financial statements are measured by different attributes depending on nature of item and relevancy to reliability of attribute measured. In present practice, five different attributes, historical cost, current cost (replacement cost), current market value, net realisable value and present value of expected future cash flows are used.

Canadian Accounting Research Committee has favoured a combination-of-values approach and suggested the combined use of current entry and current exit prices. It has proposed that:

- Monetary assets should be shown at discounted cash flow, except for short-term items where time, value of money effect is small.
- Marketable securities valued at current exit prices with adjustments for selling costs.
- Inventory at current entry prices.
- Long term investments at current entry prices.
- Fixed assets valued at replacement cost (less depreciation)
- Intangible valued at current value.
- Liabilities should be shown at discounted value of future payments, except for short-term items where time, value of money effect is small.

In short, all the earning concepts of wealth maintenance require an evaluation of total or specific assets and liabilities at the beginning and end of each period. The measurement of capital is based on expectations regarding future cash flows or on market prices as substitutes for subjective expectations and net realisable value and replacement costs. The Financial Accounting Standard Board (FASB) has favoured the financial concept of wealth maintenance while others favour physical concept.

83. Statement of Financial Accounting Concept No. 5; P.23.
84. Accounting Research Committee Discussion Paper; "Current Value Accounting"; CICA; Toronto, Canada; 1976; P.28 and PP 66-68.
2.5.2.4 ECONOMIC VALUE ADDED CONCEPT OF EARNING

Economic Value Added (EVA) is a technique for measuring business income which was introduced in 1990. It is a means for calculating the current value of the company for shareholders. EVA is a residual income measure that subtracts the cost of capital from the operating profits generated by a business. Unlike the traditional measure of accounting profit where only a part of the cost of capital (debt cost) is deducted, EVA requires deduction of full cost of capital (that is, cost of debt as well as equity). Thus, for a company which is lowly geared, cost of debt represents a minuscule part of the total cost of capital. If such cost of debt is only deducted to arrive at profit earned by the business, such profit is grossly overstated. EVA holds a company accountable for the cost of capital it uses to expand and operate its business and attempts to show whether a company is creating a real value for its shareholders. EVA is the centrepiece of a comprehensive financial management system. This implies that all the policies, procedures, measures and methods companies use to guide and control their operations and strategy centre around EVA. EVA is not a macro concept. It can be applied at a very micro level to gauge the divisional performance of a company. The most important reason to adopt EVA as the main corporate financial goal is that it is a significant measure to tie directly to intrinsic market value. Maximising EVA consistently would lead to maximisation of market capitalisation.

A company can improve EVA by following any of the three alternatives:

* Earn more profit without using more capital.
* Downsize unprofitable divisions or units.
* Invest capital in high return projects i.e., projects where the return is more than the marginal cost of capital.

COMPUTATION OF EVA

EVA is computed by applying the following measure:

\[ \text{EVA} = (r - c) \times \text{Invested Capital} \]

Where \( r = \frac{\text{Net operating Profit after Tax (NOPAT)}}{\text{Invested Capital}} \times 100 \)

\( c = \text{Weighted Average Cost of Capital (WACC)} \)

\( \text{Invested Capital} = \text{Total Borrowings} + \text{Net worth} \)

\( t = \text{Period} \)

Although B. Steward calculated NOPAT from operating income only, he did not eliminate non-operating assets from the invested capital to calculate \( r \). This is inconsistent. Also, trade investments of a company have been traditionally
considered as operating assets and income from such investments as operating income. With the relaxation made recently in the Companies Act in the provisions of inter corporate investments, investments made by a company to establish and maintain control over group companies would be very much a part of its growth strategy. Therefore, NOPAT has been calculated as Profit Before Interest and Taxes (PBIT) net of non-recurring transactions and after tax. Thus, NOPAT = PBIT (net of non recurring transaction) * (1-effective tax rate).

It may be noted that non-recurring transactions do not include other income in the form of interests and dividends. WACC is computed by applying bookvalue weights to individual costs of debt and equity. Cost of debt (Kd) is calculated as [Total Interest Expense* (1-Effective Tax Rate) / Beginning Total Borrowing].

Steward mentioned that while calculating Kd, all interest bearing debts are to be considered without distinguishing between short term and long term debts. Thus, interest costs have been calculated on total borrowings and not on long term borrowings. To calculate cost of equity (Ke), Capital Asset Pricing Method (CAPM) has been used. Finally EVA for a period is calculated on the beginning capital of that period. It can be observed that EVA depends on two factors i.e. the spread (r-c) and the invested capital. 

2.5.2.5 MARKET VALUE ADDED CONCEPT OF EARNING

Market Value Added (MVA) is a measure of shareholder wealth. If the corporate objective is to enhance shareholder wealth, it can be achieved by improving MVA. MVA is the difference between the market value of invested capital and book value of invested capital. MVA is the absolute rupee spread between a company's market value and its capital. It represents the stock market's assessment at a particular time and the net present value of company's past and projected capital. Maximising MVA, therefore, should be the primary objective for any company that is concerned about its shareholders' welfare. A company's EVA is the fuel that fires up its MVA. Thus, EVA is the internal measure of corporate performance and MVA is the external measure of corporate performance. They move in tandem.

2.5.3 BEHAVIOURAL CONCEPTS OF EARNING

Behavioural concepts of earning relate to the decision processes of investors and creditors, the reactions of securities prices in organized markets to income reporting, the capital expenditure decisions of management and the feedback reactions of management and accountants. In accounting literature, the concepts of earning at behavioural level is discussed as below;

2.5.3.1 INCOME AS PREDICTIVE DEVICE: Financial Accounting Standard Board's (FASB) Statement of Financial Accounting Concepts No. 1 states that investors, creditors and others are concerned with assessing the prospects for enterprise net cash inflows, but they often use earnings to help them evaluate earning power, predict future earnings, or assess the risk of investing in or lending to enterprise.87 Many enterprises focus their attention on their expectations regarding future earnings of the enterprise that is in relation to predict market price of the shares/stock, dividend distributions and ploughing back of earnings.

Many investors believe that prediction of future reported earnings is relevant to an evaluation of the firm’s stock in buying or selling decisions. Many writers suggest that there is some validity in presentation of measurement of earnings that will permit the projections of future earnings.

2.5.3.2 MANAGERIAL DECISION MAKING THEORY: Management is more interested in making decisions regarding current and future cash flows rather than predicting future dividends. Investors are more interested in future dividend flows and creditors are more interested in their annual return and repayment of principal when debt matures. Thus, management do react to what they consider the behaviour of investors and creditors to reported earnings.

Even though reported earning is based only on accounting structure the feedback phenomenon will affect the choice of accounting methods by management.88 For example many enterprises believe that price of their shares will be maximized if reported net earnings grow at constant rate each year.

87. American Institute of Certified Public Accountants Professional Standards; Financial Accounting Standard Board; Statement of Financial Accounting Concepts (SFAC) No. 1; FASB; USA.
88. Hendriksen Eldon S.; “Accounting Theory”; Fourth Edition; Published by arrangement with Richard D. Irwin, Inc.; Homewood, Illinois; First Indian Print 1984; Khosla Publishing House; P156.
Consequently, they choose available accounting policies and procedures to report earnings that meet this goal or report earnings per share figure that will create greatest demand for their stock.\textsuperscript{89}

2.5.3.3 ESTIMATION THEORY: This theory permit investors to predict internal rate of return (IRR) for the enterprise as a whole and thus predict future cash flows and firm's present value through the presentation of reported earnings.\textsuperscript{90} This theory has the advantage of easy to use as it does not require severe break from traditional accounting concept of earnings. It also has the advantage that it avoids most of interaction problems relating to reported revenues and expenses because earnings are computed from aggregate revenue and expenses data only. But this also appears as disadvantage to those who are accustomed to compute earnings based on individual revenue and expenses allocation. It also has its limitations in that accountant's forecasts of future cash flows which are needed to estimate internal rate of return. Would it not be easier for accountants to report their forecasts directly? \textsuperscript{91}

2.5.3.4 USER - ORIENTATION APPROACHES: Reported earnings per share or projected earnings per share do have a direct impact on the market price of common shares.\textsuperscript{92} Under user - oriented approach, though accounting concept of earnings may have no semantic interpretations, user want information for several reasons;

- Reported accounting income has become a basis for many legal and contractual relationship in society.
- Investors, rightly or wrongly, perceive a relationship between changes in accounting income and firm's cash flows including payment of dividends.
- Investors may demand earning information, as they believe that other investors use it in decision - making or other investors believe that there is

\textsuperscript{89} For many examples of misuse of accounting to influence and even deceive investors, Briloff Abraham J.; “Unaccountable Accounting”; Harper and Row; New York; 1972; and Sampson Anthony; “The Sovereign State of ITT”; Stein and Day; New York; 1973; P.142.


\textsuperscript{92} Ball Ray and Brown Philip; “An Empirical Evaluation of Accounting Income Numbers”; Journal of Accounting Research; Autumn 1968; PP 159-178.
2.5.4 CONCEPT OF EARNINGS AS PER FINANCIAL ACCOUNTING STANDARDS

One of the major objectives of the business enterprise is the maximisation of dividend flow to stockholders over the entire life of enterprise or maximisation of market value of enterprise at the end of its life. This all depends upon the overall success or failure of enterprise over its lifetime. But common objective require measurement of earning for shorter periods of time in order to provide a means of control and basis for decisions by users of accounting information, such as shareholders, creditors, management, etc. on regular basis. Overall measurement of earnings for entire life does not provide information when it is more useful nor the causes of its failure or success. Whereas causes (sources) play an important role for proper evaluation of the progress of an enterprise, net earnings for the period include all recorded economic events. This controversy led to two basic concepts of earnings — current operating concept of earnings and all-inclusive (comprehensive) concept of earnings and the intermediate position required in Accounting Principles Board Opinion No. 30 and Financial Accounting Standards Board Statement No. 16.

2.5.4.1 Current Operating Concept of Earnings: Current operating concept of earnings focus on effective utilization of business enterprise’s resources in operating the business and earning income thereon. Thus, the concept focuses on measurement of efficiency of business enterprise. In this concept ‘current’ and ‘operating’ plays a significant role. Only those values change and events that relate to current period, are considered. This statement also qualifies the use of resources and transactions acquired in prior period but used in current period. For example plant and equipment, acquired in prior period but used in current period. If a plant is adjudged obsolete in current period, may have become obsolete in prior period. The decision to abandon its use in current period may be the result of efficient management and therefore, this is not an operating event of current period. Likewise recognition of an error in computation of prior period’s earnings is not a reflection on efficiency of management in current period. Thus, errors in computation of earnings for prior periods do affect the evaluation of efficiency of management in those prior periods.

Second aspect of this current operating concept of earnings is the relevant change that arises from normal operations. The earnings in terms of normal operating activities, better reflects the efficiency of management and facilitates inter period and inter-firm comparison of business performance. The non-operating activities makes the net earning unreliable and improper device to measure the performance of business. It is also frequently suggested that non-operating activities should be reported separately because they are non-recurring. If non-recurring items arise from normal activities, the current operating earnings will include it to provide a good measure of enterprise's power and a means of projecting and evaluating income trends.94

The current operating concept of earnings is more useful in judging the profitability. It is also useful and meaningfull for inter-period and inter-firm comparisons and for making predictions. The operating and non-operating items though difficult to classify, are preferred to be shown separately. Accountants, financial analysts and other users of accounting data emphasize one figure of net earnings for the year. So if only one figure is quoted, current operating concept of earning is a better measure of current operating performance of a business enterprise.

2.5.4.2 All-Inclusive Concept of Earning (Comprehensive Earnings): All-inclusive concept of earning is the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distribution to owners.95

Thus, comprehensive (all-inclusive Concept) earning comprises;

* All changes in assets or liabilities (or both) from delivering or producing goods, rendering services or other activities that constitute enterprise's ongoing major or central operations, and
* All changes in owner's equity (net assets) from peripheral, incidental or occasional transactions of an enterprise and other events and circumstances affecting it.

95. Financial Accounting Standards Board; Concept No. 3; Elements of Financial Statement of Business Enterprise; Stamford; FASB; Dec. 1980; P.27.
The International Accounting Standards Committee States;

"Under all-inclusive concept transactions causing a net increase or decrease in shareholders' interests during the period, other than dividends and other transactions between the enterprise and its shareholders, are included in the net income of the period. Non-recurring items, including unusual items arising in current period, prior period items or adjustments related to changes in accounting policies, are included in net income but there may be separate disclosure of individual amounts."

**EARNINGS, NET INCOME AND COMPREHENSIVE EARNINGS**

Financial Accounting Standards Board (FASB) in its Concepts Statement No.5 introduced two terms; "income or earnings" and "comprehensive income or earnings". There is another term "net income or earnings". None of these terms are identical according to generally accepted concepts. The relationship among these three terms can be understood by following illustration drawn from two illustrations given in Statement of Financial Accounting Concepts (SFAC) No. 5.

**TABLE 2.1 NET INCOME, EARNINGS AND COMPREHENSIVE INCOME: THE RELATIONSHIP**

<table>
<thead>
<tr>
<th></th>
<th>Net Income (Rs)</th>
<th>Earnings (Rs)</th>
<th>Comprehensive Earnings (Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Expenses</td>
<td>80</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Gains from Unusual Sources</td>
<td>(3)</td>
<td>(3)</td>
<td>(3)</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>23</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td>Loss on discontinued operations</td>
<td>-2</td>
<td>-2</td>
<td>-2</td>
</tr>
<tr>
<td>Extraordinary Loss</td>
<td>-6</td>
<td>-6</td>
<td>-6</td>
</tr>
<tr>
<td>Cumulative effect on prior years of change in accounting principle</td>
<td>-2</td>
<td>--</td>
<td>-2</td>
</tr>
<tr>
<td>Other Nonowner changes in equity (e.g. recognised holding gains)</td>
<td>--</td>
<td>--</td>
<td>+1</td>
</tr>
<tr>
<td>NET INCOME</td>
<td>13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EARNINGS</td>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>COMPREHENSIVE EARNINGS</td>
<td>14</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: FASB Concepts No. 5.*

96. International Accounting Standards Committee; International Accounting Standard (IAS) 8; 1978; "Unusual and prior period items and changes in Accounting Policies".
As it is clear from table 2.1, the concept of earnings described above is similar to net income in practice. The difference is the inclusion in net income and exclusion from earnings of cumulative effect of certain accounting adjustments relating to past periods, e.g. adjustments arising from change in accounting principle such as change in method of pricing inventory.87

Though earnings and comprehensive earnings have same broad components - revenue, expenses, gains and losses - they are not same because certain classes of gains and losses are included in comprehensive earnings but are excluded from earnings. Those items fall in two classes;

(a) Effect of certain accounting adjustments of earlier periods that are recognised in period such as cumulative effect of changes in accounting principles included in net income but excluded from earnings.

(b) Certain other changes in net assets (principally certain holding gains and losses).

(i) Changes in market values of investments in marketable equity securities classified as non-current assets.

(ii) Changes in market values of investments in industries having specialized accounting practices for marketable securities.

(iii) Foreign currency translation adjustments (Para 42)

The relationship between comprehensive earnings and earnings means that the statement of comprehensive earnings and earnings complement each other. The statement given in para 44 of Statement of Financial Accounting Concepts (SFAC) No. 5, Financial Accounting Standard Board (FASB) states:

\[
\begin{align*}
(+Revenues) & \quad 100 \\
(-Expenses) & \quad 80 \\
(+Gains) & \quad 3 \\
(-Losses) & \quad 8 \\
\hline
(+Earnings) & \quad 15 \\
(-Cumulative accounting adjustments) & \quad 2^* \\
(+Other nonowner changes in equity) & \quad 1^* \\
\hline
(-Earning) & \quad 15 \\
\hline
\end{align*}
\]

\[
\begin{align*}
(=Comprehensive earnings) & \quad 14 \\
\hline
\end{align*}
\]

* These numbers can either be positive or negative.88


Financial Accounting Standards Board in its statement of Financial Accounting Concept No. 5 states the difference between earnings and comprehensive earnings is as follows; “Earnings focus on what entity has received or reasonably expects to receive for its output (revenues) and what it sacrifices, to produce and distribute that output (expenses). Earnings also include results of entity’s incidental or peripheral transactions and some effects of other events and circumstances stemming from environment (gains and losses). While comprehensive income is a broad measure of effects of transactions and other events (T&OE) on an entity, comprising all recognised changes in equity (net assets) of entity during a period from transactions and other events (T&OE) and circumstances except those resulting from investment by owners and distribution to owners.99

ARGUMENTS IN FAVOUR OF ALL INCLUSIVE CONCEPT OF EARNINGS

Proponents of all-inclusive concept of earning claim the following reasons for the measurement of earnings;

1. Annual reported net earnings when added together for life of enterprise, should be equal to total net earnings of the enterprise.

2. Omission of certain charges and gains (credits) from computation of net earnings lends itself to possible manipulation or smoothing of annual earning figures.

3. Income statement, that includes all charges and gains recognised during the year, is easier to prepare.

4. Financial statement users makes appropriate classifications to arrive at an appropriate measurement of earnings.

5. Too much inconsistencies in making comparisons among different enterprises or over several periods for the same enterprise, are found. As distinction between operating and non-operating transactions is not clear-cut. Transactions classified as operating by one enterprise may be classified as non-operating by another enterprise. Further more, items classified as operating in one year may be classified as non-operating in subsequent period.

In short, if the objective is to provide means of control and basis for decisions by users of accounting information, the current operating concept of earnings will be a useful measurement. But if objective is to measure total change in wealth, than all inclusive concept of earnings will be a better measure. While current operating concept of earning emphasizes current operating performance or efficiency of an enterprise, and the possible use of this figure for predicting future performance and earning power. The proponents of all inclusive concept of earnings claim that both operating efficiency and prediction of future performance can be improved if they are based on entire historical experience of enterprise over a series of years. Because useful lives of an asset extends over many periods, income producing transactions are not at uniform stages.  

2.6 RECIPIENTS OF ENTERPRISE EARNINGS

Stemming from proprietary approach, the net earnings accrued belongs to owners or current shareholders. Under entity approach, different categories of investors became interested in their share of earnings. Government and employees feel they were beneficiaries of corporation, customers and public at large interested in knowing what business is doing for them. Several concepts of corporate earnings classified by income recipients are discussed below:

(1) The Value Added Concepts of Earning

Broadly speaking, it is possible to view the enterprise as having large group of claimants or interested parties, including not only owners and other investors, but also employees and landlords of rented property. This is value added approach. In economic terms, value added is the market price of output of an enterprise less price of goods and services acquired by transfer from other enterprises. Thus, all employees, owners, creditors, and government (through taxation) are recipient of enterprise earnings.

100. Hendriksen Eldon S.; "Accounting Theory"; Fourth Edition; Published by arrangement with Richard D. Irwin, Inc.; Homewood, Illinois; First Indian Print 1984; Khosla Publishing House; PP. 159-161.

(2) Enterprise Net Earnings

Interest charges, income taxes and true profit-sharing distributions are not determinants of enterprise net earnings. These items are distributions of net earnings, rather than deductions before arriving at net earnings. Shareholders, long term debt holders, and government are the beneficiaries of the company, but not employees.

(3) Net Earnings to Investors

Both stockholders and holders of long term debt are the investors of company and they are interested in the returns on their investments. In computation of net earnings to investors, income taxes are treated as expenses. This treatment is recommended by Accounting Principle Board (USA) and adopted by Financial Accounting Standard Board, that they should be treated as expenses.

Earnings before interest and taxes (EBIT) is considered for calculation of Return on Investment (ROI) and earning before interest (EBI) is considered for calculation of return on owner's investment (ROO1). Furthermore, corporate earnings after taxes is much more stable - by industries - than income before taxes; income taxes seem to be "passed on" much as other expenses.

(4) Net Earnings to Stock-holders

Reported earnings may be used to predict future earnings, to predict long term earning ability of enterprise, or to evaluate risk of investing in or lending to enterprise as stated by Financial Accounting Standard Board in Statement of Financial Accounting Concepts No. 1. The net earnings available after interest and taxes represents the return to owners of business on their investments. Thus, stockholders are the real beneficiaries of the recipient of earnings.

(5) Net Earnings to Residual Equity Holders

Net earnings per share of common stock, dividends per share and market price per share are most commonly quoted figures in financial news to the residual equity holders or common stockholders. The common stockholders are extremely

102. American Accounting Association Committee on Accounting Concepts and Standards; "Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements"; AAA 1957; P-5.
103. AICPA Professional Standards; P.8795; Sec. 4091.13.
interested in knowing the figure of net earnings that will be available to them after meeting all the commitments. Although it is possible to view current net earnings as return to current outstanding stockholders, potential residual equity holders must be taken into consideration in predictions regarding future earnings and dividends per share. Furthermore, if current net earnings are not distributed to current stockholders, the amount added to retained earnings may be shared by these potential holders of the common stock.

TABLE 2.2: CONCEPTS OF CORPORATE EARNINGS AND ITS RECIPIENTS

<table>
<thead>
<tr>
<th>Earning Concepts</th>
<th>Earnings Include</th>
<th>Earning Recipients</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Value - Added</td>
<td>Revenue from sale minus costs of goods and services</td>
<td>Owners, creditors, employees and</td>
</tr>
<tr>
<td>Concept of earning</td>
<td>acquired by transfer (includes excise duty and VAT)</td>
<td>governments.</td>
</tr>
<tr>
<td>2. Enterprise Net</td>
<td>Revenue plus gains minus expenses and losses</td>
<td>Shareholders, long term debt holders and</td>
</tr>
<tr>
<td>Earnings</td>
<td>minus payments to employees. (EBIT) (excludes</td>
<td>government.</td>
</tr>
<tr>
<td></td>
<td>internal, taxes and dividends)</td>
<td></td>
</tr>
<tr>
<td>3. Net Earnings to</td>
<td>Earnings before interest (EBIT minus income taxes)</td>
<td>Stockholders and holders of long-term</td>
</tr>
<tr>
<td>Investors</td>
<td></td>
<td>debt.</td>
</tr>
<tr>
<td>4. Net Earnings to</td>
<td>Earnings before interest minus interest charges</td>
<td>Shareholders (preferred &amp; ordinary</td>
</tr>
<tr>
<td>shareholders</td>
<td>(EAIT)</td>
<td>shareholders)</td>
</tr>
<tr>
<td>5. Net Earnings to</td>
<td>Earning After interest and taxes minus preferred</td>
<td>Ordinary shareholders (current and</td>
</tr>
<tr>
<td>Residual Equity</td>
<td>dividends (EAITPD)</td>
<td>potential)</td>
</tr>
<tr>
<td>Holders</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


2.7 EFFECT OF PRICE LEVEL CHANGES ON CORPORATE EARNING

American Accounting Association (AAA) Committee viewed earning as “the realised net earnings of an enterprise measures its effectiveness of operating unit and is the change in its net assets arising out of (a) excess or deficiency of revenue compared with related expired cost, and (b) of profits and losses of enterprise from sales, exchanges and other conversion of assets”.

Net earnings may be conceived as the excess of revenue realised during the period by an accounting entity over the costs expired, (including losses) during the same period. Accounting concept of earnings include both return to organisation and remuneration for use of capital. Economic concept of earnings represents return for use of capital as a service charge of capital. General earning concept may be narrowed down to business income / earnings when it is applied in relation to business or accounting entity for computation of business earnings.

\[
\text{COST OF GOODS} = \text{OPENING INVENTORY} + \text{PURCHASES} + \text{DIRECT EXPENSES} - \text{CLOSING INVENTORY.}
\]
\[
\text{GROSS EARNING} = \text{SALES} - \text{COST OF GOODS SOLD}
\]

In determining business earning it is expense or cost that is matched with revenue and not vice versa.

During the course of prolonged inflation in the economy, (a) the value of money falls continuously and it loses its purchasing power; (b) the financial statements of business houses which are substantially recorded and compiled on historical cost concept fail to depict a correct picture of their profitability and financial position. Under such situation (inflation) the accepted norms for earnings determination appears to be unrealistic. As the major impact of price changes in financial statements falls on

- Depreciation, inventory and other costs;
- Profits, dividends and tax on earnings; and
- Erosion of Capital

2.7.1 INVENTORY VALUATION POLICIES

According to Accounting Standard-2 "Valuation of Inventories"; inventories generally constitute the second largest item after fixed assets, particularly of manufacturing organisations. The valuation and presentation of inventories, therefore have significant effect in determining and presenting the financial position and performance of industrial and commercial undertakings.\(^{106}\)

Accounting Standard-2 requires that;

1) The accounting policy adopted for valuation of inventories including the cost formulae used should be disclosed in financial statements. Where base stock method is used the difference between value at which it is carried and the value by which it is carried and the value by applying the method at which stock in excess of base stock is valued should be disclosed.

\(^{106}\) Accounting Standard No. 3; "Valuation of Inventories"; June, 1981.
2) Consistency is generally accepted as a fundamental accounting assumption. Therefore, any change in accounting policy relating to inventories including the basis of comparison of historical cost with NRV and the cost formulae used which has a material effect in current period or which is reasonably expected to have material effect in later periods should be disclosed. In case of change in accounting policy which has material effect in current period, the change should be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.10

Disclosure of inventory valuation can be studied on the following aspects:

a) Disclosure about composition of cost.
b) Disclosure of formulae used.
c) Disclosure about mode of valuation.
d) Disclosure about change in accounting policy, and
e) Degree of disclosure.
f) Mode of disclosure.

As a general rule Earnings = Sales + Closing Stock (Inventory include Raw Material, Stores, Work in Progress & Finished Goods) - Direct expenses. Inflated inventory values mean better earnings to impress shareholder's and this is more true when public issue is imminent. A deflated inventory valuation on the other hand accrues direct and indirect benefit in reduction of tax liability; low dividend payout; siphoning off money and worker's demand for wages. Companies Act, 1956 Schedule-VI Part-I of Section 211 stipulates that inventory should be valued at cost or market price whichever is lower and that company should maintain one system consistently for inventory valuation.

2.7.2 DEPRECIATION

Depreciation refers to systematic allocation of cost of long lived asset (such as plant and machinery building etc) to expense over the asset's useful life. Accountants usually (1) predict the length of useful life; (2) predict the ultimate residual value; and (3) allocate the cost of equipment to years of its useful life in some systematic may. This process is called recording of depreciation expense.

107. Singh Sukhdev; Disclosure of Inventory Valuation Policies in Public Enterprises", Management Accountant;, November, 1997; Vol 32; No. 11; PP 849-851.
Residual value is the predicted sales value of long lived asset at the end of its useful life. Thus, depreciation is correctly called an estimate.\textsuperscript{108}

Depreciation policy has a bearing on measurement of business earnings, as it affects all important corporate decisions like product pricing, equity earnings, profit comparison, tax payments, dividend policy, investment policy, investment potential, wage negotiations etc.

Though there are number of methods of depreciation, but the most commonly method useful for depreciating the fixed assets is the straight-line-method. In the books of account depreciation is recorded an entry debiting the Depreciation expense and crediting contra-asset account accumulated depreciation.\textsuperscript{109}

\subsection*{2.7.3 INTANGIBLE ASSETS}

Intangible assets are non current assets and have no physical substance. They represent either special rights and privileges protected by law - Such as patents, copyrights, trademarks, franchises, and lease holds - or goodwill, which is a value placed on such factors as superior management ability and customer loyalty. Only those intangibles that have been acquired at cost should be recorded in accounts for accounting purposes.

\section*{AMORTIZATION OF INTANGIBLE ASSETS}

Amortization is systematic allocation of cost of an intangible asset over its useful life. Generally accepted accounting principles require that all intangibles be amortized over a period not to exceed 40 years.\textsuperscript{110} Thus, they should be amortised over their expected useful life, their legal life, or 40 years, whichever is shortest. Unless strong evidence exists to defend use of alternative method, Amortization must be calculated using straight line method.\textsuperscript{111}

\textsuperscript{108} Horngren Charles T. & Sundam Gary L.; Introduction to Management Accounting; Ninth Edition; P 631.


\textsuperscript{110} AICPA; "Accounting for Intangible Assets"; Opinion of Accounting Principles Board No. 17; New York; 1970; Para 29.

\textsuperscript{111} Ibid; Para 30.
Goodwill occurs when the value of entity as a whole is greater than the sum of value of entity's individual assets less liabilities. It cannot be purchased or sold independently of other assets. Goodwill is a prime example of intangible assets for which useful life and realizable value cannot be reasonably determined. For this reason only cost of goodwill purchased as part of acquisition of one entity by another entity is recorded in accounts.\textsuperscript{112}

2.7.4 INCOME-TAX EXPENSE POLICY OR EROSION OF CAPITAL

Earnings is the difference between revenues and costs which are normally recorded in terms of current values. Under conventional systems of accounting, cost becomes mixture of current and historical costs; on contrary, revenues are always recorded in current values. Historical costs creep into total cost mainly in shape of depreciation, cost of inventories etc. Such creeping in of historical cost into total cost usually results in overstatement of earnings or understatement of losses. Overstatement of earnings causes extensive capital erosion by excessive payment of income tax and dividends over the lapse of time.

Income tax expense is determined by multiplying current tax rate by taxable income of corporation. Income tax expenses are recorded in each period by adjusting entry debting income tax expenses and crediting Income tax payable.\textsuperscript{113}


2.8 SUMMARY

Earnings represent business success and wealth maximisation. Earning data is very useful in dividend decisions, managerial efficiency measurement, predictions and economic decisions. Traditionally, earnings are measured according to accounting concepts, conventions and policies by matching revenues and expenses. This approach has been criticized due to its dependence on realisation principle, cost allocation methods and historical cost accounting. As an alternative to accounting concept of earning, economic concept of earning is suggested which is measured in real terms and results from changes in value of assets. Economic concept is theoretically sound but difficult to measure accurately.

Earnings measurement focuses on capital maintenance concept on financial and physical basis. Financial Accounting Standard Board favoured financial concept while some other favoured physical concept. Since, Physical concept is useful for users in predicting amounts, timing and risk associated with future cash flows and understanding enterprise performance in real terms, Earnings measurement is discussed at structural level and behavioural level. Structural concept of earnings relates to transactions (both internal and external) and activities approach. Transaction approach involves recording of changes in asset and liability valuations only as these are the result of transactions. Activities approach focuses on a description of activities of firm rather than on reporting of transactions. Behavioural concepts of earning relates to decision processes of investors and creditors, the reaction of securities prices in organised markets to earned reporting, the capital expenditure decisions of management, and the feedback reactions of management and accountants.

Earnings in a business enterprise is mainly generated through its ongoing major activities but earnings may be derived from developments outside normal operations of business such as capital gains or accounting changes. Investors require information about different components of earnings to assess the “quality of earnings”. Quality of earnings generally refer to durability and stability of earnings. Among different components of earnings, earnings based on recurring (operating) items is generally more useful to economic decision makers in predicting future income and cash flows.