CHAPTER I

CONCEPT OF EARNINGS
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INTRODUCTION

Earnings can be said to be the first of all economic activities. This is the driving force of any business activity, whose ultimate aim is to earn profit. It is the basis as well as the aim of the entrepreneur to get profit in a business. No investors, proprietors, managers, businessmen, traders can be successful without getting profit. Therefore, earnings have become the basis for the economic development of a nation. In the absence of this concept, the production and distribution systems are bound to be affected adversely. That is why the socialist countries have realised the importance of earnings, which is, excess of income over expenditure. The total quantity and the rate of profit earnings is the measurement of any business activity. This provides the basic incentive to investors, proprietors and others who are directly or indirectly concerned with business activity.

With the introduction of profit sharing schemes and bonus to workers and shareholders, earnings have become a matter of special concern to workers, trade unions and shareholders. Earnings thus stand for the creation of surplus and refer to the efficient utilization of resources, essential for the rapid economic growth. It is the earnings which makes the business and industry run. They provide gainful employment for the livelihood for the people. The meaning of profits in modern corporations is
quite different from that of proprietorship and partnership concerns. In the case of corporate bodies, ascertainment and apportionment of earning are governed by the provisions of various corporate laws and tax laws rather than by accounting principles. With the fast increase in economic activities carried out by the present corporations, their earnings have increased enormously and subsequently the management of earnings have assumed special importance. The government takes away the lion’s share of these earnings by way of the corporate tax before they are actually distributed to shareholders.

Present management faces two fold problems while distributing their earnings i.e. on the one hand to retain a large portion of the profit, in the business fund, required for future expansion and modernization needs of a company or on the other hand, to decide to distribute a large portion of profits by way of dividend to its shareholders.

Thus it should be clear and understandable that a wrong dividend policy may put the company into financial problems and the capital structure of the company may get imbalanced. The growth of the company may get collapsed if sufficient profits are not available to implement growth programmes which are to be undertaken in future for expansion programme.

CONCEPT OF EARNINGS:
Earnings are a very controversial concept. There is no commonly accepted meaning of the term which could serve the different objective and purposes of it. The term earnings means the reward
or payment received in exchange for the production of goods and services. "It is the entire return received by the business". For example, the salary received by a clerk is his earnings, since it is the reward received by him for his services.

Similarly, the rent received by the owner of the property is his earnings, which is the reward for the services rendered by him through his property. The concept of earning ranges from the view that "the pure profit is the residual income after deducting from total income, wages, interest and rent". Since earnings derived from various sources, earnings are called mixed and vexed income. Classical Economist Irving Fisher is the first amongst those who explained the concept clearly as "the flow of benefits from wealth and through a period of time". The stock of wealth existing at a given time is called capital. According to Hicks, it is the money value of the net accretion to economic power between two points of time. The main objective of its calculation is to give people an indication of the amount which they can use without improving themselves. No doubt that these views have been expressed in understandable language but they do not provide a basis for measuring or evaluating the performance of the business enterprise. The consumption approach may be useful for individual but not for the business enterprise. One can measure the accretion of economic power by comparison of capital values in the beginning and at the end of the accounting period. Therefore, the concept of earning is essentially an accounting concept.
ACCOUNTING CONCEPT:

In accounting, we are mainly concerned with business earnings, a term which is synonymous with the term 'Business Profit'. It can be defined as the excess of the income over expenditure incurred by the business over a period. According to Smith, "the net earnings for the period is the excess of revenue realised during the period by a specific accounting entity over the cost expired [including losses] during the same period."

* The most accepted definition of earnings is that which has been given by the American Accountants' Association "the increase in the net assets of business which can be measured by the excess of revenue over cost." Thus according to this definition, earnings are the outcome of the following:

1) Excess of revenue over related expired cost.
2) Gains to the enterprise from sales, exchanges or other conversion of assets.

Moreover, according to the American Accounting Association the term Business Earnings involves, realised net earnings and not earnings only. It means earnings will be considered to be business earning only when it has been actually realised.
There are three types of cost, original, current and replacement cost. These types of costs are concerned with financial accounting. Original cost implies the actual or historical outlay, which were actually recorded in the books while acquiring the assets or incurring the expenses. Current cost refers to the cost of which the assets can be acquired or disposed off at a given time. Replacement cost means the cost at which the assets can be replaced at a future date. Cost analysis helps in finding out the relationship of cost and revenues to output. It enables the financial manager to study the general effect of the level of output upon income and expenses and therefore upon profits. It helps in understanding the behaviour of profits in relation to output. Such an understanding is significant in planning the financial structure of a company.

According to this concept, business enterprise should be consistent in the accounting practice that it follows in the treatment of its assets, liabilities, revenues and expenses. It may sometimes be impossible for the accountant to follow the concept of consistency in business enterprise. Estimation and assumption may be required in the treatment of different items and it should be based on the accounting principles. For example, provision for contingencies and outstanding expenses have to be estimated, thus the measurement of business earnings also depends to a great extent upon the basis regarding treatment of different items, which form part of the income statement of the business.
The earnings from a business enterprise can be determined only at the end of its life, i.e., when business is finally closed down. Business earnings are determined after the expiry of reasonable period. The earnings disclosed by the income statement are then income made during the accounting period. The actual earnings earned by the business will be known only when the business is finally closed down. Thus the measurement of accounting income is also subject to the accounting period concept.

It is clear that net earning is the difference between gains and losses on income and expenses or revenues and cost.

It can be concluded that the accounting concept of earnings is computed when the business is finally closed down. The earnings disclosed by the income statement are the income made during the accounting period which is always expressed in a years range, say calender, fiscal or otherwise.

**ECONOMIC VIEW POINT**

The Economist’s concept of the term earnings is different from that of an Accountant. According to the accounting concept the term profit or earnings is computed by deducting the expenditure incurred from the total revenue for earnings that revenue. "However, from the Economist’s point of view earnings are defined as the favourable change in wealth which takes place due to business operation". This definition does not give a clear picture of earnings. "According to the Economists, the term earnings means "the current flow of goods and services over a period of time."

* S.P. JAIN, K.L. NARANG
  Principles and Practices of Accountancy.
However, this definition is more satisfactory because while determining earnings, an Economist considers both monetary and non-monetary aspects. For example, if a factory is started and successful, it will give more opportunities to the people and more employment and thus it will earn monetarily. However, if the factory was running unsatisfactorily and is unsuccessful, it will lead to unemployment and no more opportunity for the people and thus it will not earn monetarily. An economist, while determining the impact of the starting of the factory on the earning of the people, will consider both monetary and non-monetary aspect, and the cost of income determination. In other words, while determining the earnings after deducting the cost, expenditure incurred from the revenue.

There are many types of costs:

[i] Relevant cost and irrelevant costs.
[ii] Short run cost.
[iii] Long run cost.
[iv] Sunk cost principle.
[v] The point cost principle.
[vi] Fixed and variable cost.
[vii] Out of pocket cost.
[ix] Incremental costs.
[x] Direct and indirect cost.
[xi] Opportunity costs and historic costs.
[xii] Implicit and explicit cost.
Relevant costs and Irrelevant costs:
Costs that will be incurred as a result of a decision are the relevant costs of decision making. Costs that have been incurred already or which will be incurred in any case are Irrelevant Costs as far as current decision making is concerned. The successful manager, as he takes any decision, will always ask himself which costs the relevant and irrelevant for a particular decision.*

SHORT RUN AND LONG RUN COSTS:
The short run is defined as that period of time during which the physical capacity of the firm is fixed and during which output can be increased only by using that existing capacity more intensively. The long run is a period of time during which it is possible for the firm's physical capacity to be increased or if trade is bad enough, reduce in size.**

THE SUNK COST PRINCIPLE:
This principle implies that when several inputs go into one process which yields several outputs, the cost of total output, cannot be known exactly. But there is no way to allocate total costs among the outputs.*

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* EVAN J. DOUGLAS [Managerial Economics]
  Theory, Practice and Problems.

** By FLOYD E. GILLIS, JR [Managerial Economics]

• D.C.HAGUE [Managerial Economics]
  Analysis for business decisions.
A fixed cost is one that does not change with an increase or decrease in volume of output during some time period, generally unspecified.

A variable cost is one that does change according to output during some time period, and gain generally unspecified.

- A product cost is one that can be directly related to the output of a product, given a period of time specified as a fiscal year.
- A period cost is a cost related not to a given output, but to the passage of time, namely a fiscal year.

- OUT OF POCKET COSTS:
Those costs which result in the drawing down of some asset, usually cash, in or near, to the time period in which the revenues are generated.

- WASTING COSTS:
The decline in value of any and all assets associated with the venture during the firm period in which the revenues are generated.

- INCREMENTAL COSTS:
Incremental costs are defined as the change in overall costs that result from a particular decision being made. If may be fixed or variable and a new decision may require purchase of additional capital facilities and extra labour and material.

* FLOYED E. GILLIS [Managerial Economics]

**DIRECT AND INDIRECT COST**:  
In the business firm some costs are incurred in such a way that can be directly attributed to the production of a particular unit of a given product. The use of raw materials, labour inputs and machine time involved in the production of each unit can usually be determined. On the other hand, the cost of fuel for heating, electricity, office and administration expenses, depreciation of plant and buildings and other items cannot easily and accurately be separated and attributed to individual units of production.

**IMPLICIT AND EXPLICIT COSTS**:
Implicit costs are costs of self owned and self-employed resources such as salary of the proprietor or return on the entrepreneur's own investment. These costs are frequently ignored in calculating the expenses of production.

On the other hand, explicit costs are the paid-out costs, i.e., payment made for productive resources purchased or hired by the firm. They consist of the salaries and wages paid to the employees, prices of raw and semi finished materials, overhead costs and payments, and provision for depreciation and sinking fund accounts. These are firm's accounting expenses.

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* EVAN J. DOUGLAS [Managerial Economics]  
** K.J. DEWET [Modern Economic Theory]
OPPORTUNITY COST:

Opportunity cost arises when an opportunity to earn income is forfeited or on equivalent amount of money spent wastefully. Opportunity cost of a decision is the sacrifice of alternative, where some or all resources are in limited supply to the firm. Other use of the scarce resource must be given up in order to make it available for the particular use. Opportunity cost arises when factors are owned by the producer himself and he is not obliged to anyone else in order to obtain them. Here are some specific illustrations of the meanings of opportunity cost.

[1] Opportunity cost of using a machine to produce a particular product is the sacrifice of earnings that would be possible in using the machine to produce other products.

[2] Opportunity cost of funds tied up in one’s own business is the interest [or profit corrected for differences in risk] that could be earned if these funds were invested in other ventures.

* The opportunity cost has two closely related, yet distinct concepts: Explicit and Implicit cost. Explicit cost are recognised in accounting, e.g., payments for raw material and labour. Implicit or [imputed] costs are sacrifices that are not recognised in accounting, e.g., use of capital supplied by owners of the business. Opportunity cost may or may not contrast with explicit accounting cost.

Example—

* W.WARREN HAYNES AND WILLIAM R. HENRY
Managerial Economics [Analysis and cases, Page NO.2]
Case No.1 When the opportunity cost is greater than the explicit cost:

If the firm owns land, there is no cost of using the land [rent] in the firm’s accounts. However, if the firm is giving up the revenue that could be realised by renting the land to another firm, then the firm has an opportunity cost of using this land. So the opportunity cost is more than the implicit cost.

Case No.2 When the opportunity cost is the same as the explicit accounting cost:

If the firm buys materials from an abundant supply in the open market, there is an explicit cost of the materials in the firm’s accounts. The next best use of these inputs would be not to purchase them, thereby making the money available for any other desired use. Thus opportunity cost becomes the same as explicit cost. The concept of opportunity cost focuses attention on the net revenue that could be generated in the next best alternative use of a scarce input [or bundle of inputs]. Thus, this concept helps considerably in evolving reasonable standard and norms of profit because it is not enough to know that the firm is making profit. Rather the crux is to know whether the profits earned are sufficient enough in view of the climate and opportunities available to the business firms.

With new operations research techniques, the minimum or normal rate of return on capital investment in a particular project or a business firm is taken as the opportunity cost [or normal expected profit] while comparing the actual performance. Thus
the normal rate of return becomes the opportunity cost of every business decision, because of the fact that the money spent on one venture implies that there was some other venture left out due to lack of funds or relatively low return from them. In an enterprise, the normal rate of return may be the minimum desired rate of profit said by the management. But "this phenomenon is after all a rule of thumb and management can alter it, at will". Thus the normal rate of return or opportunity cost cannot be taken as the cost of earnings. At the most, it can be treated as an alternative to earnings.

As regards financial sources, there exists competition between Government and private external entrepreneurs. To a great extent, the normal rate of interest is determined by Government's monetary and fiscal policies. "Thus the Government rate becomes a minimum price. It forms the opportunity cost for all users of the funds". However, an adjusted rate may be taken as an expected rate of earnings after taking into consideration all the peculiar features of the ventures like risk, certainty and stability of the profit as well as the recouping capacity of the capital invested. Thus, a single rate of return cannot be suitable for all types of business investment. Business decisions lack scientific basic and cannot be governed by pure economic calculation, but are curious mixture of rationalization and Intuition.

* FLOYED GILLIS - Managerial Economics, Page No.5
** Keirstedd Balance Sheet/Capital, Interest and Profit Page No.7.
Thus it is wrong to provide theoretical superiority to the economist's viewpoint on earnings. The definite earnings, has its foundation in the accountant's approach, particularly when cost has become the best conceived basis for measurement of earnings.

Further, the problem of evaluation which determines the earnings belongs to the accounting world, without which the economic viewpoint is to lose even the logical precision. Many financial experts like *Carl L-N and his followers suggest that instead of reporting profits, Management should furnish information about those elements that affect profits and performance on the basis of specific decisions in specific area viz.,


CONCEPT OF INCOME - INDIVIDUAL AND NATIONAL

The Dictionary meaning of the concept 'income' is "money or other benefit periodically received; the gain derived from capital or labour or both; inclusive of profit gained through the sale or conversion of capital assets". Mr. Louis Goldberg in his article 'A Distinction Between Profit and Income' expresses clearly that the concept of individual income represents the sum total of resources - whether measured in a monetary or non-monetary unit which become available to him for the satisfaction of his wants and desires. He also considers individual income as a positive concept in the whole-life stage.

As such concept of 'income' changes according to the nature of events; it is said to be 'earned income' when income received from labour, professional work or business. Income from capital investment is treated as 'unearned income'. Encyclopedia Britannica makes the concept of income much more inclusive - the total payment accruing to the households of a nation, including wages, rental income, proprietors' income, dividend and interest payments and transfer payments. Income from which personal tax payments can be subtracted is known as personal disposable income. Encyclopedia Britannica also includes payments accruing to the members of a nation in return for the use of their labour and capital services. So the total of all individuals' income and the income from the capital services is treated as national income.
If we represent individual income as I, Income by capital services as \( C_1 \) national income as NI, we would express the national income thus,

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NI = I + C_1
\]

For an individual, Hicks defines 'income' as the maximum amount a man can consume in a period and still be as well off at the end of the period as he was at the beginning. He also points out the difficulty of determining what precisely we mean by being as 'well off' at one date as at another. It is obvious that to measure the well off position of an individual or a nation at different points of times is a difficult task.

No close agreement has ever been reached between the accountants and the economists regarding the concept of 'Business Income'. Accountants complain that economists are too idealistic and their concepts are impractical. On the other hand economists allege that accountants are too mechanical and their procedures are not based on sound principles. In the following lines we make a brief comparison of Business Income in accounting and in economics.

In accounting, business income is generally conceived as the residual from maturing revenue realised against cost consumed. It is a money concept measured periodically for a specific firm through the tool of the income statement. Revenue is recognised mostly on the basis of sales. Expenses or cost consumed are measured on the basis of original cash or equivalent, prices arrived at between two independent parties. Accounting income
is, thus, the difference between the revenue realised and costs consumed. IAS 12, specifies that 'Accounting Income' is the aggregate income or loss for a period; including unusual items* as reported in the income statement, before deducting related income tax expenses or adding related income tax savings.

In Economics, business income is viewed as the maximum amount which the firm can distribute as dividends and still be as well off at the end of the period as at the beginning. 'Being well off economically' is interpreted as 'maintaining capital intact' in terms of the discounted value of expected future net receipts. Income occurs as soon as there is an increase in net worth. In modern economics, the firm may be viewed as an economic organism with a preferred 'state' of equilibrium reflected by balance sheet. The income making process is simply the movement of the firm from one position towards another position. If the firm moves into a 'better' position we say that income is generated; otherwise, loss is incurred. To be better of economically a firm must increase its real net worth.

The economists' concept of the term 'profit' is also different from that of an Accountant. According to the view of the Accountant, the terms 'Income' and 'Profit' are synonymous.

* Unusual items is defined in IAS 8, 'Unusual and prior period Items' and changes in Accounting policies.
'Profit' or 'Income' is computed by deducting from the total revenue, the expenditure incurred for earning that revenue. However, an economist regards profit as a return of a factor of production like wages, interest and rent etc.

Thus the concept of income changes its shape according to the benefit earned by using various input factors. The labourers' earnings in terms of wages is the 'income of labour, land owner will get 'rent' as terms of 'profit' for using his intelligence. 'Interest on capital' is the income for the investor (investment in the form of capital). In all these cases the overall connotation of income is similar. But if it is measured factor wise it gives different meanings for the concepts of income. In case the entrepreneur provides both capital (investment) and land (input factor), the respective earnings from these input factors say interest on investment and rent - are not recorded. In these cases the meaning of income changes according to the situations. The concept of income is inconsistent in all these cases.

Hicksion's income demands that in evaluating net worth, we capitalise expected future net receipts, while accounting income only requires that the evaluate not assets on the basis of their unexpired cost. We may sum up the relationship between these two different concepts of increase in networth, economic income and accounting income by starting with accounting income and arriving at economic income thus:
Accounting Income

+ unrealised changes in the value of tangible assets which took place during the period - over and above value changes recognised as depreciation of fixed assets and inventory mark downs.

- amounts realised this period in respect of value changes in tangible assets which took place in previous periods and were not recognised in those periods.

+ changes in the value of intangible assets during the period.

= Economic Income.

FASB statement of Accounting concepts, assumed that accounting income is a good measure of a firm’s performance and that accounting income can be used in the prediction of future cash flows. Other writers assume that accounting income is relevant in a general way for the decision models of investors and creditors.

Firstly income is measured in terms of 'ventures' or 'activities' performed. In case of 'contracts' the entrepreneur (contractor) measures his income only after the completion of the contract without considering the time factor. 'Activity Accounting' where income measurement is based on the 'activities' performed or 'ventures' completed is not important these days, due to the enactment of various laws, like Income Tax Act, Government policies, Regulations etc. Hence, 'period accounting' i.e.,
measurement of income on the basis of a period of time like month, year etc., has become important.

In economics, business income is defined as the maximum amount that the firm can distribute as dividends and be as well off at the end of the period as at the beginning. We should not conclude that only economic income satisfies this central concept of income. To be as well off economically, a firm must maintain in fact the present value of the expected future net receipts of the capital.

If we define 'revenue' as increase 'in all assets' and decrease in all liabilities', and costs consumed as deceased in all assets and 'increase in liabilities', then the difference between the two should also be equal to economic income derived from valuation of networth in terms of expected future net receipts* through the tool of the balance sheet.

Economic income is measured by valuation by valuation of assets, whereas accounting income is recognised only when a sale is effected. Emily Chen Chang in his article 'Business Income in Accounting and Economics' briefly expresses three basic differences between accounting income and economic income.  

1. Because of changes in business prospects we have the problem of accertion versus realisation as the criterion for income recognition.**

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* With the adjustments for price level changes.

** This problem may rise under a number of circumstances, but it is particularly important under conditions of change in business prospects.
2. Because of changes in price level changes, we have the problem of inclusion versus exclusion of unexpected gain.

3. Because of changes in price level changes, we have the problem of real income versus money income.

In a world where everything changes from time to time and nothing stands still, these three basic issues will continue to plague us. Hence, accounting income and economic income will never in agreement. In conclusion it may be of interest to mention that the concept of taxable income appears to be no less confused than that of business profit.

LEGAL AND TAX VIEWPOINT:

In the modern era of ever-increasing state interference in the economic and business activities, the Government possess the sovereign power to levy taxes on profits earned by an individual and companies.

In democracy, the law-making powers are increasingly falling in the hands of politicians. The concept of earnings, like many other such things, is governed by the attitude of legislators towards savings. Recently the legislature has become over-enthusiastic in enlarging the scope of taxable income, so as to ensure equitable distribution of wealth and income, as well as to tap the financial resources for rapid economic development.

In India, the Income Tax Act recognizes the two basic attributes of earnings viz. a] sources and b] periodicity. Accounting and economic concepts are accepted indirectly by exempting receipts
of casual and non-recurring nature. The definition of income given in the Act is inclusive as well as exclusive. The concept of income has been enlarged from time to time. Savings in the forms of perquisites, benefits and amenities have been treated as taxable income in the hands of recipients. Capital transactions too are taxed under the head of 'capital gains'. Capital itself began to be taxed when in 1964 bonus shares issued to the shareholders became taxable income. Even the net worth of company exceeding Rs.5 lakhs was taxed in 1959-60-62. Thus, from the legal aspect taxable income has become a hotch-potch of the earnings and capital receipts.

The old proposition that taxable profits are the real profits of the business, determined in accordance with the accepted principles of commercial accounting, is losing ground. Postulates of tax laws have become predominant. Tax incentives, allowances, rebates and exemptions, which are a sort of gifts to the taxpayers from the legislature, determine the income of different persons and business concerns differently. Political ideology and economic policies have greater bearing on the grant of incentives like full exemption of income from agriculture interest from certain approved securities, tax-holiday to new undertakings, partial exemptions and rebate on profits from priority industries, export trade, income from royalty and technical services to the foreigner, provision for development rebate, allowance for capital expenditure on scientific research, promotion of family planning and so on.
Another important proposition that man cannot trade with self nor
can he make profit and lose out of the transactions with himself,
contains only half the truth in the present context. There are
several provisions in the Income Tax which impose an artifical
dichotomy on a tax-payer and tax the gains missing out of
transactions between his two different capacities. Prior to
1960-61, tax paid by the Company on their income was deemed to
have been paid by shareholders who were given credit for the same
in their personal assessment. However, after 1960-61, Company
has been taken as a legal entity quite distinct from its
shareholders. It pays tax on its own behalf. Thus Company now
pays two taxes namely, [i] Corporation tax on their profits and
[ii] Advance tax on behalf of shareholders by way of deducting
tax at prescribed rates from the dividend payable to them.
Concluding the remarks of the three concepts of earnings, the
first return to periodic reforms from capital stock. Return is
called "Flow" and as Capital stock fund. Earnings are mainly
concerned with the profits and gains. Accordingly, "earnings
possess two attributes viz. sources and periodicity".
Computation of earnings from the economic view refers to the
compensation of Capital values at the beginning and at the end of
the period. Thus the economic concept is a long and theoretical
term on real income rather than money income. Its practical
aspect is dealt with in books of account by matching the revenue
with cost. On the basis of actual realisation accordingly, the
excess of revenue over costs is treated as earnings. This is
especially a short term phenomenon based on realised money
gains. The legal aspect of earnings is reflected in the
provisions of tax laws, wherein receipt may become taxable as income even without containing any element of profit. 'Earnings' is not necessarily the recurring return from a definite source. Anything, which is described as income under law, becomes taxable income unless expressly exempted; based on prudence and justice, income is the best conceivable measure of the ability to pay taxes. However, the taxable income is selectively determined and is not a comparable and consistent income. Frequent changes in legislative and administrative provision caused by social and political objectives make the taxable income quite different from the economic and accounting income. In the long run the difference can be removed by reconciliation of divergent viewpoints of legislators.

In spite of considerable thinking that has been best owed on the subject a perfect definition of income is yet to be evolved. There is no dearth of definitions of course, but none of them is entirely satisfactory. The most common definition of income is that given by "Rebort Murray Haig" "Income is the money value of the net accretion to one economic power between two points of time".

However, these definitions limit income to money income alone, and therefore a more comprehensive definition is very much to be prepared. The problem of the income concept lies in its exact relationship to capital, for, capital in its broadest sense generates income. According to JR Hicks, the term income is the amount which a man can consume away in a given period of time.
without impairing the production ability of his capital. Perhaps Hicks does not take into account the factors of savings, for, it is not necessary that all income should be consumed away. In Hick's approach, says Kaldor, capital appears only as the capitalized value of ascertained future prospect and income as the "standard stream equivalent of that prospect". Thus capital and income become one and the same thing, those expressed into different ways. However plausible this reasoning may look, it actually involves secular reasoning.

Irving Fisher and recently Nicholas Kaldor have defined income as the value of a given flow of services. This flow which has taken into account is the net flow emanating from one's property, thus "it follows that saving and appreciation in capital value are always capital and not income. They are saved from being invested". This definition tries to solve the vexed problem of capital gains by intimately linking up savings and appreciation in capital value with capital.

From the definitions discussed above we may summarise the characteristics of income as follows:

1] Income is the flow which could be measured only between two points of time, and it is distinct from capital, which is, the reservoir or stock at any given amount;

2] Income is the flow which takes place without injury to the capital;

3] Sometimes, however, capital may be raised in value, thus leaving a gap between the present value and the past value. It becomes necessary therefore, while computing income, to
take also into account the invisible gains in the value of capital. From the purely economist's point of view, income is a net accretion in real terms. As J.R. Petrie says, "the economic concept of business profit/income involves matching current replacement cost against sales income". Accretion in the value of capital, caused only by changes in the general price level, is not income for, these in no way increase the net gain in real terms. As far as corporation is concerned the income of profit is the residue from the gross income after deducting every expenditure incurred to achieve the gross earnings without impairing the value of the capital stock, plus the accretion in the value of capital.

However, deceptively simple it may look, the practical application of the concept to tax purposes is faced with innumerable difficulties. As opposed to the economist's concept of real income, the accountant's concept takes note of the money income only. For example, an economist will give importance to items like imputed interest on equity capital and imputed price to scarce factor of production in order to determine the real net income. However, in a broad view of the matter, accounting ideas of income are not after all very different from the economist's concept. Hotfield refers to "the increase in proprietorship which has taken place during that period, making due allowances for any part of such increment as may have been distributed and adds, "this is the broadest use of the terms but is one
which is occasionally employed by both accountant and economist."

However, in somewhat narrow sense, accountants limit income only to realized money gains since the accounting concept uses money as the standard of measurement, some times it has to include unrealised increments in value. In the practical affairs of business, the economist's concept cannot be used. If for example, it excludes withdrawal and new investment in computing income, because it is a net concept. So much so, as Charles John Gaa says, in the accountant's concept, "in order to face practical difficulties and to gather information in the most convenient and economical manner, theoretically correct ideas regarding income calculation are often deliberately side-tracked for more expedient methods.

The definition of income or profit for tax purposes is mainly based on the accounting practice on the one hand and the administrative limitation on the other.

As far as the corporation is concerned, the problem is the presentation of the net profit, which is gross earning minus the costs plus the capital gains. Thus the essential idea behind taxation is not only the severance of current cost, but also the separation of capital from the total gains.
The determination of cost, then, is the most important problem in the calculation of the total taxable income. There can be no two opinions, of course about wages, raw material, salaries, rent etc., which inevitably go into the cost of production. Even so, interest on borrowings constitute some problem. Sometimes owing to the dividend being taxed twice, corporations might resort to borrowed financing. Interest could be treated as a cost of production, whereas dividend could not be. Richards Goods rightly considers this as "illogical" in the tax treatment of corporate earnings used to pay interest and corporate earnings available for dividend declaration. Yet he too comes to the conclusion that "in view of the practical difficulties and probable economic repercussions, it seems that expansion of the corporate tax base to include interest and net rent paid whole be undesirable. Ultimately the problem of taxable income could be solved only by the valuation of the current assets, and fixed assets. The valuation of the opening and closing inventories is the determinant of the cost of goods sold and thus the net income.

Generally inventories are valued at cost or market price whichever is less. However, this method tends to exaggerate the profit or loss in times of sudden or sharp shifts in the price level. The capital goods used in the production of commodities are naturally used out. Invariably, owning the passage of time the equipment used
becomes obsolete. Moreover, in the industries like mining forestry etc., the marketable material such as oil deposit, coal and timber come to be completely used up in the course of time. Income from such industries is actually derived from the sale of capital itself. This creates the problem of wearing out of capital. It may be a slow process but one can visualise the end of all the same. It is therefore desirabel, that extent of wearing out, obsolescence and deplation should also be included in the current cost of production and such cost should be deducted from the gross earnings. As William Vickrey correctly say, "depreciation is deducted in order to permit the tax payer to recover intact and free from income-tax his capital investment in plant and equipment. In principle depreciation should reflect the decrease in the value of the capital arising from gathering, wear and tear, exhaustion of useful life and absolute. Ultimately the total of all depreciation deduction plus the scrap value will be equal to the cost of replacing the same asset when its useful life has been exhausted. In calculating depreciation allowances many estimates have to be made like - the life of the asset and the cost of replacing the asset. Groves, describing the depreciation estimates has remarked "the process involves so many variables and innumerable that it may be closer to guess work than the estimating. As a general rule conditions of inflation and deflation tend to distort profit and loss statements because of their effects on depreciation, inventory valuation, etc.
Economic and accounting concepts are objective concepts, whereas the same under the corporation tax laws are subjective. Hence economic and accounting concepts need an independent and impartial treatment. The essence of accountant's professional position lies in their independence. Accountants have to guide the manufacturing and investing public through their objective approach towards earnings of business concern. They being experts cannot afford to be mainly influenced by the subjective outlook prescribed by law. They should certainly assist and advise in the determination of tax affects, without compromising their professional integrity. Thus the task of an accountant is of greater significance than that of an economist. The economist simply conceives and sees earnings in their abstract sense, whereas the accountant being rather active with the concept of earnings views things in their real form.

CORPORATE EARNINGS:

Corporate bodies are the creations of law and the Law always has the right to define the sense in which the term "Co-E" shall be sued. By their very nature, Corporate earnings include more than the pure profits and returns for entrepreneur's risk, but may not include executive incentives, compensation and certain other items deducted in the process.*

* STEW AND NELSON  Page No.17.
Corporate legislations have been enacted in almost all the countries of the world, wherein detailed provisions regarding determination and distribution of earnings have been made. In India, the functioning of Corporate sector is governed by Companies Act, 1956, and is subjected to some controls like industrial licensing, control of capital issue, import licensing, control of distribution and prices of some selected items. Corporate earnings have been dealt with most scientifically taking into consideration the accounting practices and the reasoning of law. The law has always sought to impose accounting practices by insisting on full disclosure of the true and fair financial position and by establishing an enlightened, auditing profession. Legal restraints have been imposed to ensure proper preservation of contributed capital and distribution of dividends out of earned profits. The spirit of the law is based on the judgement delivered in the famous case of Guinness. The Land Corporate of Ireland, as early as 1883, which reads as "the capital of the Company, as mentioned in the Memo, is to be the fund which is to pay creditors in the event of the Company being wound-up." From that it follows that what is described in the Memo as Capital cannot be diverted from the objects of the Society. It is of course liable to be spent or used up in carrying on the business of the Company, but no part of it can be returned to a member so as to take away from the fund which the creditors have a right to look upon as that, out of which they are to be paid.
As regards the provisions pertaining to Corporate earnings incorporated in the Indian Company Act, it is said that while a Company is required to prepare its accounts in the form laid down in Schedule VI of the Act, its ascertained profits differ for different purposes. For example, profits for income tax purpose will be determined from these accounts, but on the basis laid down in the Income Tax Act the profits available for distribution of dividend have to be ascertained in accordance with the Section 205 of the Company Act, 1956, while the net profit of the Company for the purpose of Computation of remuneration is determined as per provision of Section 349 and 366 of the Company Act, 1956.

No standard form is prescribed by the law for the preparation of the Profit and Loss Account or Income and Expenditure Account of the Company, as has been done for the Balance Sheet. There are different types of industries and business concerns; one set of forms cannot meet the requirements of all of them. According to Section 211[2] of the Company Act, every Profit and Loss Account, Balance Sheet of Company shall give true and fair view of the profit and loss of the Company for the accounting year and shall comply with the requirements of part II of Schedule VI, so far as they are applicable thereto. Thus the Company Act gives greater emphasis on the application of the doctrine of disclosure of the accounts of the Company, i.e., the published accounts of the Company must be honestly prepared, and all the information, which is significant not only to the shareholders but also to the general public, must be disclosed therein. The auditors, who certify the account to be true and fair, have a right to insist
on the disclosures of the relevant information which they deem necessary. The officers who are in charge of accounts and allied functions are required to furnish such information to the auditors without delay. If any person knowingly makes a default in performing this duty, he is punishable with imprisonment upto 6 months or with fine of Rs.500/- or both. Thus the auditors are in a position to safeguard the interest of investors to a considerable extent.

In fact, it is the practice of the Corporate Taxation and not the doctrine of disclosures, which in a real sense has a great bearing on the meaning of the computation of corporate earnings. Under Income Tax, all profits and gains accruing to the owner of a business are taken as his earnings after deducting therefrom all business expenditure. Besides the ever-changing rates of Tax and Surcharge, the classification of the Company into domestic or otherwise, provision for the development rebate on new investment in fixed assets, tax exemption to priority industries and deduction and reliefs in respect of a good number of example are the main determination of net and distributable earnings of the corporate. Under the Income Tax rules 1962, of W.D.V. of the depreciation of assets good as well as evil effects of tax and depreciation policy on corporate earnings have been dealt with in separate places in Chapter II of this study.

It should be remembered that corporate tax is levied on net earnings attributable to the Preference and Equity shareholders. Interest on debentures, and borrowed capital is allowed as a
usual item of business expenditure. It is thus clear that, like the Indian Company Act, the Income Tax also does not provide any specific meaning of earnings. Customary items like Gross Profit and Net Profit, being very vague and misleading, have outlined their utility and do not serve any purposeful objective, because of the superiority of tax legislation over the corporate law. For the purpose of this study the different types of earnings have been computed on the following basis:

1. Main earnings: Net Sales - Cost of goods sold
2. Total earnings: Main earning + Non-operational expenses [P.B.T.]
3. Taxable earnings: Total earning - Interest [P.B.T.]
5. Pay out [dividend]: Dividend declared on Profit and Equity

Total earnings are the main source of income wherefrom corporation pays the interest on borrowings and tax and appropriates the balance between dividend and retained earnings. Retained earnings are created by segregating the portion of distributable earnings to various accounts like G.R.D.R. Res., D.E.Fund, Capital Red Fund Profit and Loss fund etc. Besides the Retained earnings or excess payout, capital transactions like premium on the issue of shares, forfeiture of shares, discount on redemption, bonus issue, capital gains and losses have been the important items which increase or decrease the quantum of corporate surplus.
CASH FLOW CONCEPT OF EARNINGS:

Cash flow concept of earnings has been recently developed by American financial experts like Diran Bedenharn.*

Cash flow is a useful concept to be used as one of the tools of investment analysis. It is significantly different from the conventional concept of earnings. Ordinarily the earnings reflect the excess of revenue over the cost of goods sold during the year. Thus the earnings are primarily concerned with the activity during the year within which corporation functioned. Cash flow in financial analysis means net income after adding back expenses items which currently do not use funds, such as depreciation and it is typically referred to as internally generated funds. The cash flow is the flow of cash and other benefits which accrue to the shareholders in cash or in kind. In other words, cash flow is equal to the market value of equity at the end of the year \([M_2]\) plus the dividend received during the year less market value in the beginning \([M_1]\).

Therefore cash flow \(= M_2 + \text{Div.} - M_1\) Dividend is received in token as business profit or normal profit, whereas difference in the market values \([M_2-M_1]\) is treated as pure or capital profit or loss or example, if the cash balance of business is shown by its balance sheet on 31. Dec. 1981 at Rs.40,000 while the cash balance as per its Balance Sheet on 31. Dec. 1982 is Rs.50,000 through has been on inflow of cash of Rs.10,000 in the year 1982 as compared to the year 1981. The cash flow explains the reasons

* S. and Nelson [Profit in modern Economics, P. No. 98]
for such inflow or outflows of cash. If we assume that change in the market value correctly reflects the change in the net worth caused by the change in corporate surplus, there will be no material difference between the cash flow concept and the traditional view.

Cash flow helps the management in making plans for the immediate future. The management should search to plan the inflows and outflows of the funds of the firm with the goal of maximizing the value of the actual holders of the equity interest as that interest existed at the moment of the choice. This concept is also useful to capital investment appraisal. In India the market value of share cannot be taken as a reasonable basis for the calculation of earnings. Public company constitutes about 1/4 of the total corporate units registered under the Company Act and about 80 % of such companies are listed with different stock exchanges. However, the shares of all listed companies are not quoted regularly and the number of transactions were quite meagre, governing securities of a few leading corporations only.

RECENT TRENDS:

It would not be out of place to discuss recent trends in the concept of earnings before analysing the problem of management thereof.

1] Before the advent of Joint Stock Company it was difficult to compute earnings scientifically. Most of the business was carried on by sole traders and partnership firms where entrepreneurship was not a separate entity. In earlier days of Income Tax, earnings were imperfectly understood as
net cash increase and were ascertained on cash basis. The process of rationalization of Tax structure developed the principle of accrual. The earnings are now determined on accrual basis in accordance with the tax-payers’ regular method of accounting. Thus, because of legal and accounting considerations governing the working of modern business, economists feel relieved of the difficult task of defining the earnings. Of late, greater attention is paid to the size and uses, i.e., adequacy and appropriation of earnings. That is why the problem of management has come to the forefront.

Recent development, favouring specialization and division of labour, big size and mechanisation have led to an increasing concentration of assets in the hands of salaried personnel. In spite of the fact that the corporate laws have been designed to safeguard the interest of the shareholders, they have been degenerated to more dividend recipients, rather than controlling proprietor. For lack of expertise and time they remain unorganised and diffused. In countries like India, directors who have been charged with multifarious duties find themselves helpless in this respect.

There has been a great change in the attitude towards profits. The object of maximisation of money profits has given way to the minimisation of costs and losses, but only as a secondary and less important one. The primary objectives are narrated as continuous growth-wise and
timely response to the public expectations. Profits are sacrificed for the sake of fulfilment of social objectives. The working of public sector in India and other socialist countries presently is a typical example of this new thinking about profits.

4] The present day techno-structure [Professional Period] of the Company is more concerned with the growth than the rate and the quantum of earnings. It is the growth which increases the authority of individual managers, creates more opportunity for promotion and enlarges their power and influence. This is much more tangible and direct reward for them than an improvement in earnings. They show greater evidence of social conscience and consider the State as a guarantee for a long-term survival. They welcome State intervention in economic sphere concerning production, pricing, profits and other policies for the public good.

5] Further, the corporations once so independent of public criticism have now become very much concerned about their public image. In developed countries of the West, Corporations invest their funds into prestigious projects of social importance. On the other hand, Socialist Governments of developing countries divert corporate earnings into social amenities through heavy taxation even at the cost of industrial growth.

6] After the second world war there has been a big change in
the working of overall economy. Industries have gone to fill many new demands for consumption and capital goods. Slowly, the seller's market has given way to buyer's market, where the buyers are more choosy than ever before. Expansion of key industries aiming at permanent growth has now created substantial surplus capacity resulting into low rate of earnings. International competition has lowered the margin of profit. Advanced countries are facing the problem of excess capacity at home and of no entry abroad.

In India, the process of economic development has been stimulated through State Planning. The main objective of planning is to get the best use of available resources on priority basis attaining thereby more production at lesser cost. Industrial licensing and various other measures have been adopted to combat the evil effects of competition on the one hand and monopolistic conditions on the other. Because of inadequacy of financial resources more use of deficit financing has been made, resulting into inflationary bound scarcities, providing a sheltered market to many producers. Elements of risk and uncertainties have nearly faded away. Because of these conditions earnings have become somewhat assured even to an inefficient undertaking. The Government policy of restricting competition, as reflected by a variety of controls over the demand and supply of a large number of consumption and capital goods, has unfortunately given filling to monopolistic trade practice and ever increasing evil
effects of black money and concentration of economic power into a few hands. In many cases, it has encouraged unethical standards of conspicuous consumption. Profits are viewed with suspicion. Vehement criticism levelled against the profits of big business by socialists, on egalitarian grounds, has been gaining momentum. Financial aggregates of costs, sales and profits of the corporate units have caused the critics to lift their eyebrows. It is widely believed that the private corporations are making for more profits than most of their earnings by way of salaries and taxes and keeping loss for themselves. This belief, together with an ever increasing governing demand for revenue, has led to the faster growth in the corporation tax during the last two decades, whereby the Government has emerged as the major beneficiary of the increase in the corporate earnings. Corporation tax alone has taken 37% to 53% of pre-tax profits.

Fast rise in the costs and taxes and price stabilizing measures have invariably led to an earning squeeze. Large financial commitments, resorting to mechanization and automation, lay a constantly heavier claim on capital market. There is a world wide speculation as to whether the earnings, [the fuel of economic system] will be adequate to equip the economy with the expected growth. The earnings or the absence of earnings may become a deciding factor for economic development, as they ultimately determine the degree of business confidence and willingness to invest further.
STATEMENT OF PROBLEM:

Corporate Finance deals with the financial problems of a corporate enterprise. These problems include the financial aspects of the promotion of new enterprises period. The analysis of financial problem is an important aid to earning-analysis. The traditional approach to the scope of earnings was different from the modern approach. The term earnings was treated by the traditional approach in the narrow sense because the management was not considered as an essential part of business enterprise. The conceptual framework of the traditional approach to earnings ignored the importance of management in business enterprise. Today the modern approach views the term earnings in a broader sense because the management considered as an essential part of business enterprise. It provides a conceptual and analytical framework to the successful running of an enterprise at all levels. The Management guides and regulates investment decisions and expenditure. It guides the entire process of earnings. As a result of disequilibrium and differential profit potentialities in the real world, the opportunities for substantial contribution to profit making by an efficient and professional management are abundant.

Income measurement is one of the most important problems in accounting. Before 1920 the main emphasis in financial reporting was on Balance Sheet as the statement of the financial soundness and solvency of a business unit. The reason was probably that the contributors and the users of finance were bankers and leaders whose sole interest was in seeing in the Balance Sheet
the short term liquidity of the concern than the Income statement. The suitable measure was accounting income and was computed by making a comparison between the state of affairs of a business at two specific dates generally by and interval of a year.

During 1920 and 1930 the Balance Sheet slowly becomes the residual statement resulting from the process of measuring income. The growing importance of reportable business income was further added by the increasingly complex tax system. Tax was on income, not on wealth and it caused accountants to concentrate on the measurement of income figure to find out tax liability. After the attainment of Independence and the advent of planning, there has been a progressing expansion in the scope of the corporate sector in India and it was the most important part of the national economy. The Corporate sector is generally set up with large capacities even larger production up to the full capacity and its activities are broad and diversified, covering more than 90% of the main factory production. Because of the predominance of household agriculture and proprietary and partnership business, corporate sector is restricted to industrial and financial activities occupying about 16% of the national income. The adoption of socialist planning in India was essential and helpful to promote rapid economic growth. Economic planning makes it possible to use potential production resources in the most effective and fruitful manner and in this way ensure rapid economic growth.
The distinction between the public sector and the private sector has been significant since the passing of the Industrial Policy Resolution in 1948 and 1956 making India a mixed economy. In a broad way the public sector is entrusted with the responsibility of developing heavy and basic industries, Social and Economic infrastructure, while the private sector is given the right to develop consumer goods industries. The private sector has the larger sphere of operation and expansion of the industries. The private investment was more interested in quick yielding industries and in large profits in as short a period as possible. It was considered most suitable to for consumer goods industries which involves skill, capabilities, and expertise.

The procurement of adequate amount of capital and the management of earnings are the two fold problems of the corporate finance. As a matter of fact, management lies more in the management of earnings than in the procurement of finance. After obtaining the necessary amount of capital, the next important function is to invest and utilize the procured capital in such a way that the investors may get an adequate return on their investment and the capital too may remain intact. The efficient utilization of capital and the management of earnings depend upon the internal administration of enterprises. The more the earnings capacity of the company, the higher would be the profits. Prior to their distribution in the form of dividend, a part is retained, reserves are created for various purposes and then only the balance is distributed among the owners of capital. This
procedure is technically termed as Management of Earnings. In the words of Gerstenberg "Management of earnings includes the management of each phase of the company's business because it involves income or expenditure".

Thus the concept of management of earnings means appropriation and ascertainment of earnings. The entire profits may not be distributed amongst the owners of capital, but a part of the earned profits is ploughed back or retained to be utilized in future for financing schemes for meeting working capital requirement, of the company. Sometimes a part of the total profits is transferred to the various reserved like reserve fund, renewal fund, replacement fund and sometime, secret reserves are also created without the knowledge of the shareholders.

The trend since past fifty years has emerged wherein the increasing use of the corporate system for correcting into readily transferable form of ownership of large on more or less permanent business enterprise. In such a trend the concept of earnings assumes a special significance because there is diversified ownership of the corporations by stock holders. This evaluation has led into certain process of law and accounting. The legislation, tax legislation in particular, has a vital bearing over the ascertainment and appropriation of such earnings. The state takes major share out of these revenues through taxation before distribution of such earnings amongst the

* DR.S.C.SAKSENA [Business Administration and Management]
Page No. 56.
stock holders by way of dividend. The management is in a fix in such a situation. It has to meet the two way problem, wherein he has to pay steady and adequate dividends to satisfy the rate of return anticipated by the investor. Also, it has to ensure that adequate portion of earnings is ploughed back to justify the capital requirements of the business.

It is thus clear that the traditional view of earnings based on the maximization of money profits has withered away. The rationale of earnings is not given a free play in both developing and undeveloped economies. Reasoning demands that in the interest of economic growth social factors should not completely supersede the economic facts. Profits should be considered as an important ingredient of economic development and profitability as an index of surplus proving the capacity of an undertaking, so necessary for its survival and expansion. Earnings, being the reward for assuming risk, is the means by which the private investor is compensated for his social service of voluntarily accepting the financial risk involved in providing on economic good. The term profit may be avoided by the socialization of all means by production but the sustenance will remain so long as the desire of consuming public is held to be the most important determinant of production. An equivalent of profit 'residue' will have to be relied upon as the only effective guide to the allocation of production sources.

* HOWARD BION AND MILLEV UPTON - Introduction to Business Finance - Page No.21
OBJECTS OF STUDY: The following are the objectives of net earnings.

1] Net Earnings gives an idea of the return on capital employed. It gives an idea of overall efficiency of the business. This includes distribution of earnings, retention of earnings.

2] The ascertainment of earnings is essential for the corporate tax because income tax is levied on the basis of earnings. It includes the effect of tax law over the actual earnings, disclosed earnings and accounted for earnings.

3] The ascertainment of net earning emphasises the need to distinguish between invested capital and earnings. This distinction is helpful in paying dividends out of income only and not out of capital. If there is no net earnings, it is possible that dividend may be paid out of capital leading to erosion of capital which is not desirable. Dividend should always be paid out of revenue profits.

4] The use of earnings-figure is a very useful and helpful guide because in evaluating the use of scarce resource the activities which give higher return on scarce resources are to be preferred to increase the wealth of the business.

5] With the help of net earnings, the profitability of a capital project can be ascertained. When the project is yielding higher return it will be favoured. Thus net earnings reporting is a useful and helpful tool for making capital budgeting decisions.

6] To study the impact of accounting policies employed by the
companies on the earnings with reference to the accounting policies employed by the companies in India. This will include the study of consideration upon which accounting policies are formulated.

7] For the purpose of giving a portion of the profit to the employers, ascertainmnet of net earnings is a must. Trade unions feel satisfied when net earnings are reported to them because these unions can see that workers are not being exploited and their due share in profit is being given.

8] The appropriation policy of corporate earnings is a complex and multi-angled phenomenon. It depends upon the capital structure of the company, the debt content and operating leverage. The capital structure affects the post tax earnings of the companies. Thus, the study will include the appropriation and distribution policies of the companies.

It can be concluded that to ensure the correctness of the flow of earnings in the business, it is most essential and logical to take it into account all the costs incurred while earning such revenue. Thus this concept assumes that costs or expenses of a business of a particular period are compared or matched with the revenue of that period in order to ascertain the net profit or net loss. If revenue earned is more than the costs, the result is net profit or net earning. On the other hand, if costs are more than the revenue, the difference is net loss. No revenue is
considered as revenue unless the costs in respect of such earnings are considered. Similarly, no cost is supposed to have been incurred unless it produces results in the form of revenue. Thus, costs and revenue of a particular period are matched or composed through a financial statement called profit and loss account.

SCOPE OF THE STUDY:
Procurement of an adequate amount of capital although a significant task before administration, because the dexterity of management lies more in the management of earnings than in the procurement of capital. After obtaining the necessary amount of capital, the next important function is to invest and utilize the procured capital in such a way that the investors may get an adequate return on their investments and the capital too may remain intact. However, procurement of capital is comparatively an easier task and it depends more on the condition of the money market. But efficient utilization of the capital and the management of earnings are delicate issues which depend upon the internal administration of enterprises. The procured capital is usually invested in the further procurement of men, machines and materials and the ultimate result of this investment is either profit or loss, which in turn depend upon the earning capacity of the company. The more the earning capacity of the company, the higher would be the profits. Creation of ill planned reserves, unsound depreciation policy, and absence of scientific internal financial control are symbols of defective administration of income and may lead to liquidation. Hence, rational management
of earnings is considered as an important tool of business administration. The scope of management of earnings includes

a] declaration of dividend or dividend policy

b] Ploughing back of profits

c] Creation of Reservers or determination of profits, surplus and Reservers

d] Provision for depreciation or depreciation policy.

1] **DIVIDEND POLICY**: A successful company while recognizing the need of distributable part of its net profits as dividend, must make provision for meeting the fixed charges eg. rentals, interests, taxes, payment on the funded obligations and for additions to surplus. Internal financing is mainly dependent upon the adoption of a suitable dividend policy. The ownership objective of the business enterprise is required to be fulfilled by the distribution of satisfactory dividend to the shareholders. The desirable aim of all companies should be the establishment of a stable dividend policy which aids in a raising additional capital, enhances reputation and increases the value of their scarcities. For the maintenance of a stable dividend rate, the management is often justified in paying no dividend during the first few years in the case of a new and growing company which required funds for developing and improving the company’s business.

2] **PLOUGHING BACK OF PROFITS**: The concept of ploughing back of profits is a management tool under which the entire
profits are not distributed amongst the owners of capital, but a part of the earned profits is ploughed back or retained to be utilized in future for financing schemes of betterment of development and for meeting the working capital requirement of the company. If an existing company wishes to finance any scheme of expansion or modernization, utilization of the ploughed back or retained profits is the best device. Ploughing back or investment of a part of the profits is an ideal method of financing expansion and improvements.

3] DETERMINATION OF PROFITS SURPLUS AND RESERVES :

A. PROFITS

The importance of correct determination of profits cannot be over-emphasised. Its various advantages may be enumerated as follows:

i] Correct reporting to the Shareholders : The most important characteristic of a company form of organisation is that there is divorce between ownership and management. The real owners of the company are the shareholders but the task of management is entrusted to a handful of persons, technically known as Directors. Directors are no doubt, the representatives of the shareholders, hence, under the Company Law, it is their legal duty to report to the shareholders about the earnings of the company managed by them. Hence, accurate computation of profits is necessary so that the shareholders may be kept in touch with the true financial position of a
company.

ii] Dividend declaration depends upon the determination of profits

iii] Intensive use of capital can be ascertained by the earning capacity.

iv] Ascertaining the operating efficiency of the company.

v] Future expansion of the company

vi] Easy in obtaining loan

vii] Determining the basis of merger or consolidation

viii] Correct taxation

ix] Ascertaining importance of industry in the national economy.

Sources of Profits: The principal sources of earning for a company may be classified into three groups:

1] Income from the main business. Internal financing or ploughed back of profits depends mainly on the income from this main source. The higher the profits, the heavier would be the reserves of retained earnings.

2] Income from other sources. Any other income, besides that from the main source, falls under this head. The term 'other sources' refers to those sources which are allied to the main objective. Such income is separately shown in the accounts of the company.

3] Income from investment. More often than not, the surplus funds of a company are invested in the purpose of securities or other companies. Such investment may be permanent or temporary. Certain companies are
legally bound to invest part of their capital in first class or government securities, e.g., banks and insurance companies. Income from investment is also separately shown in the final accounts of a company.

**Advantages of Stable Earnings**

Stability of revenues is one of the aims of business [i] the stable flow of income simplifies the task of management by facilitating long term planning and enabling it to control the performance efficiently. [ii] it permit the enterprise to maintain its organisation [iii] it also helps in building a sound capital structure [iv] for casting and business budgeting can be done successfully on proper lines [v] stable dividend policy depends consideraly on stable earnings [vi] it increases the credit worthiness of a company which can have adequate loaned capital of a reasonable rate of interest. [vii] stable earnings also help in keeping the price steady which is beneficial from the standpoint of consumers.

**Factors Affecting the Stability Earnings**

The stability of gross earnings depend upon the following elements:

1. **Natures of Business**
   - It is a notable fact that enterprises dealing
   - a] basic goods and essential services
   - b] low priced commodities
   - c] non durable goods

Consumer goods have more stable earnings than earnings
those dealing in luxurious, high priced or novelty goods, heavy goods and raw materials,

2] Size of the Business : Size of the business has a salutary effect in keeping revenues steady where size is result of product diversification. Enterprises characterized by large scale production upto a certain point at least have wide margin of profit when compared with those of smaller concerns, and can stand temporary losses than the small company. Also, they have the means to purchase basic commodities in advance of price increases.

3] Possession of Element of Monopoly : Other things being equal a concern that enjoys some elements of monopoly will have a steadier revenue than one that is subject to the vicissitudes of a competitive regime. The monopoly benefits may arise on account of patents, copyright, particularly locational site.

B. SURPLUS :
The concept of surplus is based on different views expressed by the people. * According to one school of thoughts the balance remaining after deducting the liabilities and share capital from the assets of the company is technically called 'surplus'. In other words surplus represents the 'undistributed earnings' of the company, i.e., the balance of profits which

* DR. S. C. SAKSENA [Business Administration and Management] Page No. 62
remains after paying the dividend. In simple words, 'surplus' may be described as the net income of the company remaining after paying the dividend and other expenses. It reflects upon the sound earnings capacity of the company. It is regarded as a welcome sign by the management. It helps in equalizing the dividend rate. For example, if due to inadequacy of profits, a company is not in a position to pay dividend at the usual rate which it had been maintaining for the last four five years, the retained surplus which may be in the form of dividend equilization fund can be utilized to make up the gap and maintain the same rate of dividend payment. Thus both company and management are benefited by the policy of 'maintaining a surplus'.

C. PROVISIONS AND RESERVES:

Provisions should be made in business also for all possible contingencies. According to the Companies Act 1956, the expression provision shall mean any amount written off or retained by way or providing for depreciation, renewals or diminution in value of assets, retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. The term 'reserve' has not been specifically defined in the Act, but it refers to that amount which has been provided for any purpose other than those mentioned below. It has been stated
in part III of Schedule VI that "any amount retained by way of providing for any known liability, is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose of this schedule as a reserve and not as provision."*

Reserves may be of various kinds:

1] **Capital Reserve**: It represents those reserves which might be created out of profits of capital nature. Such reserves cannot be utilized for dividend distribution, their main objective is to stabilise the economic condition of the company.

2] **Specific Reserve**: It is usually created for specific purposes, e.g., for the payment of outstanding expenses, for depreciation renewals or development.

3] **General Reserve**: It is that part of the profits of the company which is set aside for meeting any future emergency. Its various purposes may be i] to stabilise the economic condition of the company, ii] to meet the increasing demands of the business, iii] to meet the casual losses, or iv] to control the real profits of the company.

The complex phenomenon of management of earnings has many facets and is characteristically complex and widely discussed. For the purpose of analytical study there was a dearth of financial data from the companies in the privat-

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*DR. S. C. SAKSENA [Business Administration and Management Page No. 63*
sector. Therefore, representative sample of such companies has been used in the study. The sources of financial data were Annual Reports, Stock Exchange Directories and Financial Express. The period for the scope of study is limited to 1985 to 1990. To confirm that the sample is representative, the companies in all the categories are selected and the following factors were decisive in the selection.

a] Product group  
b] Paid up capital  
c] Value of net assets  
d] Turnover

The statistical method and ratio analysis has been appropriately used. The stratification of companies has been made on the basis of capital employed, into small, medium, large. The small companies are the ones possessing capital worth one crore. The medium companies possessed capital employed worth one crore to three crores. The large companies capital worth exceeds three crores. Capital employed consists of total paid up capital plus free reserves and borrowings. The computation of capital while classifying the companies is taken as overall capital employed during the period.
LIMITATIONS:

1] There is no uniformity in accounting year period by all the companies. Hence, for the purpose of analysis and comparison a part of the whole calendar year is assumed to include all the accounting period which end during any time in the calendar year.

2] The information used has derived from published financial statement where the figures are subjective and thus it may not be sufficient to have conclusive findings. For example the law in India does not compel the companies to disclose the accounting policies and therefore comparison of the performances cannot be done conclusively.