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CHAPTER 27

Capital, value and income

Setting the scene

Current financial reporting suffers from a number of deficiencies. It concentrates on the legal form of transactions more than on their economic substance and frequently does not reflect economic reality, it concentrates on the past rather than the future, it concentrates on cost rather than value and it leads to too much attention being paid to 'profit' and not enough to wealth and changes in it.

(ICAS Research Committee, 198[illegible])

Learning objectives

After studying this chapter you should be able to:

1 discuss the significance of capital maintenance and describe the different conce[illegible] that have been postulated;

2 explain the relationship between capital and income;

3 identify the purposes for which businesses require income measurements.

We stated in Chapter 2 that the objectives of financial reporting to inv[illegible] should be found in the decisions which investors have to make abou[illegible] investment in companies. Hence, we argued, financial reporting should be co[illegible] with the provision of such information as is required for making those dec[illegible] We assumed, also, that investors were principally concerned with the worth [illegible] investments in two senses. First, they are concerned with maintaining and [illegible] ing the value of their capital. Second, they are concerned with maintain[illegible] increasing the income which is derived from that capital. Financial reporting [illegible] to be concerned, therefore, with the valuation of shareholders' capital and [illegible] In accordance with the stewardship concept of financial reporting, feedba[illegible] mation is required in order that investors may ascertain the current value [illegible] capital and income. The decision-making concept of financial reporting as[illegible] financial reports should contain information which is useful in assisting inv[illegible] predict future changes in capital and income.

Three main concepts involved in financial reporting are capital, value and [illegible] Together they provide the focus for this part. The purpose of this chapter [illegible] duce and explain the nature of these three concepts.

To the economist, the term 'capital' relates to those assets which are used in the production of goods and services. The capital of the firm is represented by the firm's stock of assets, and investment by the firm occurs when the stock is increased. From the point of view of society, the term 'capital' is restricted similarly to those assets which produce goods and services. Capital includes, therefore, physical assets in the form of buildings, plant and machinery, housing, hospitals, schools, etc. as well as intangible assets such as technology, human skills (human capital), etc.

In accounting theory, a person's capital is increased by the amount of his periodic income which he has not consumed. Financial accounting procedure effects this transfer by crediting the net profit to the capital account, and if the level of consumption, or drawings, is less than that profit, the capital is increased by the difference. In the case of companies, dividends are analogous to drawings, and retained profit is added to the total of the shareholders' equity. One of the important implications of profit measurement in the case of companies lies in calculating what may be safely distributed as dividends.

Early writers on bookkeeping recommended, as a first step in the record-keeping process, the preparation of an inventory or statement of capital showing all the personal and real property, as well as debts due and owing on the first day of business. Paciolo in 1494 advised the businessman to prepare his inventory in the following way:

> *First of all, he must write on a sheet of paper or in a separate book all his worldly belongings, that is, his personal or real property. He should always begin with the things that are more valuable and easier to lose. . . . He must then record all other things in proper order in the Inventory.* (Gene Brown and Johnston, 1963, p. 27)

It is evident that at this stage of development, accounting made no distinction between personal capital and business capital. In the course of subsequent developments, however, a distinction emerged between total wealth and wealth committed to business activities. Whereas in Paciolo's time capital was taken to mean the entire amount of what was owned, the capital account became ultimately a device which described and quantified that portion of private wealth invested in a business enterprise.

The development of the entity theory of accounting, as distinct from the proprietary theory, which culminated in the appearance of the joint stock company, gave expression to two important notions. First, as we saw in Part 2, an enterprise could be separated from its owner by a legal fiction and used by the owner as a vehicle for conducting business. Second, the fictional life granted to the enterprise by accounting practice, and additionally in the case of corporations by law, was to serve limited purposes. The capital account was to remain the umbilical cord linking the enterprise to its owner or owners. In line with this view, the enterprise continued to be regarded as an asset and this view has important implications for the valuation of capital and income.

From the foregoing, it is evident that there are some fundamental differences between economists and accountants in the manner in which the notion of capital is conceptualized. As Littleton (1961, p 244) points out, the balance sheet presentation of 'capital' emphasizes its legal rather than its economic aspect, for capital is shown as a liability, whereas in economics, capital refers to assets. The assets held by a business and actively employed by it are usually greater in value than the so-called 'capital'. In the light of modern interests, we may say that the terminology of financial reports in this respect is misleading. However, supposing that the total assets employed by an enterprise were to be redefined as its 'capital', there remain a number of problems:

1 the valuation of business capital;
2 the valuation of investors' financial interests, that is, personal capital;
3 the methods selected for these valuations;
4 the manner in which these valuations are to be communicated.

From our previous discussion of the objectives of financial reporting, we may say that investors are interested primarily in the valuation of their shareholding and this valuation is dependent on the valuation of business capital.

Capital maintenance

We stated earlier in this chapter that investors are concerned with maintaining the value of their capital. The concept of capital maintenance is central to discussions regarding price level adjustments. There is general agreement that income is a residue available for distribution once provision has been made for maintaining the value of capital intact. Difficulties begin to emerge when discussion turns to the consideration of the meaning of 'capital maintenance'. Several alternative interpretations of this concept have been offered and are considered below.

The money amount concept

The aim of this concept is to maintain financial capital in money terms. Consequently, the measurement of periodic profit should ensure that the monetary value of the shareholders' equity is maintained intact. In effect, the profit of the period amounts to the increase in monetary terms in the shareholders' equity measured between the beginning and the end of the period. It is this amount which may be distributed to ensure that the money capital is maintained intact. The money amount maintenance concept is reflected in historical cost accounting.

The financial capital concept

The objective of this concept is to maintain the financial capital of an enterprise in real terms by constantly updating the historical cost of assets for changes in the value of money. The translation of historical asset cost is effected by a retail price index, and results in the representation of asset values in common units of purchasing power. This concept of capital maintenance purports to show to shareholders that their company kept pace with general inflationary pressures during the accounting period, by measuring profit in such a way as to take into account changes in the price levels. In effect, it intends to maintain the shareholders' capital in terms of monetary units of constant purchasing power. The use of a retail price index based on a range of goods and services restricts adjustments for changes in the purchasing power of money to those changes which would be experienced by consumers.

ing capability concept

The financial capital concept of capital maintenance views the capital of the enterprise from the standpoint of the shareholders as owners. Hence, it reflects the proprietorship concept of the enterprise as regards both income and capital, and seeks valuation systems which fit this view. By contrast, the operating capability concept of capital maintenance views the problem of capital maintenance from the perspective of the enterprise itself, thereby reflecting the entity concept of the enterprise.

The operating concept states that the productive (operating) capacity of the enterprise should be maintained as a prime objective in the course of profit measurement. The operating capability concept of capital maintenance asserts that income is a residue after provision has been made for replacing the resources exhausted in the course of operations. In this view, 'there can be no recognition of profit for a period unless the capital employed in the business at the beginning of the period has been maintained. . . . The starting point will be the various items making up the capital' (Goudeket, 1960). The criteria imposed on income measurement by the operating concept are reflected by the system of replacement cost accounting, in which assets are valued at their replacement cost to the firm. Replacement cost accounting takes into account changes in the prices of commodities specific to the enterprise, either directly or by using specific price indices to measure changes in the prices of similar commodities.

disposable wealth concept

Whereas all previous concepts of capital maintenance envisage the enterprise as a going concern, the disposable wealth concept suggests that the maintenance of capital should be viewed from the perspective of the realizable value of the assets of the enterprise. Accordingly, the measurement of periodic income is required to take into account changes in the realizable value of the net assets attributable to the shareholders' equity. At the beginning of the accounting period, the shareholders' equity, defined as the capital of the enterprise, is valued by reference to the realizable value of assets, after deducting realization expenses. A similar valuation of the net amount which would accrue to shareholders from the realization of assets is made at the end of the accounting period.

The disposable wealth concept of capital maintenance is based on the proprietorship theory of the enterprise. However, it interprets this theory in terms of the 'exit' rather than the 'entry' values of enterprise assets.

Income

The concepts of capital and income are closely related. Irving Fisher expressed their relationship in 1919 as follows: 'A stock of wealth existing at a given instant of time is called capital; a flow of benefit from wealth through a given period of time is called income' (Fisher, 1919, p 38).

An analogy may be found in the relationship between a tree and its fruit – it is the tree which produces the fruit, and it is the fruit which may be consumed. Destroy the tree, and there will be no more fruit: tend the tree with care and feed its roots and it will yield more fruit in the future.

Once the concept of value is introduced into the relationship between capital and income, however, the exact nature of this relationship becomes clearer. According to Fisher (1969, p. 40),

> *It would seem . . . that income must be derived from capital; and, in a sense, this is true. Income is derived from capital goods, but the value of the income is not derived from the value of the capital goods. On the contrary, the value of the capital is derived from the value of the income. . . . Not until we know how much income an item will probably bring us can we set any valuation on that capital at all. It is true that the wheat crop depends on the land which yields it. But the value of the crop does not depend on the land. On the contrary, the value of the land depends in its crop.*

Economic and accounting theory are both concerned with the relationship between capital and income and the implications of this relationship. There is agreement between accountants and economists on a number of aspects of the relationship and considerable disagreement as regards the valuation of capital and income. There is agreement, for example, that only income should be available for consumption, and that in arriving at a measure of income, it is necessary to maintain the value of capital intact. Since the ultimate aim of economic activity is the satisfaction of wants, it follows that income is identified as a surplus which is available for consumption. The valuation of income in this analysis is subject to a fairly conservative criterion which Hicks expressed as follows: 'The purpose of income calculations in practical affairs is to give people an indication of the amount which they can consume without impoverishing themselves' (Hicks, 1946).

Income plays a central role in many business and personal decisions, since it is based essentially on the notion of spending capacity. As Hicks pointed out, income should be an operational concept providing guidelines to spending. As applied to business corporations, Hicks's definition of income has been interpreted as the 'amount the corporation can distribute to the owners of equity in the corporation and be as well off at the end of the year as at the beginning' (Alexander, [illegible] 139). It is evident, however, that income is used for other purposes as well. For this reason, we examine the objectives of income measurements before proceeding to the analysis and selection of appropriate concepts.

The objectives of income measurement

Income as a measure of efficiency

Income is used as a measure of efficiency in two senses. First, the overall efficiency of a business is assessed in terms of income generated. Hence, income figures provide the basic standard by which success is measured. There are clearly [illegible] focusing upon financial efficiency to the detriment of other concepts of efficiency – such as the effectiveness of the business as a social unit and [illegible] in developing and using new ideas and processes. Nevertheless, those [illegible] the use of income as a measure of business efficiency argue that in the [illegible] all other aspects of efficiency converge on income. Second, shareholders [illegible] efficiency of their investments by reference to reported income. Hence, [illegible] of investment funds, the selection of portfolios and the operations of [illegible] system depend upon income as a standard by which decisions are taken.

a guide to future investment

The selection of investment projects is made on the basis of estimates of future cash flows. These estimates are self-sufficient to the extent that risk and uncertainty have been sufficiently discounted in the decision-making process. In a more general way, however, current income acts to influence expectations about the future. This is particularly so as regards investors who have to rely on financial reports and whose willingness to hold and to subscribe for further shares will be affected by reported income.

as an indicator of managerial effectiveness

Management is particularly sensitive about the income which is reported to shareholders since the effectiveness of managers both as decision makers and as stewards of resources is judged by reference to reported income. It is in this respect that auditors play a key role in ensuring that the statements placed before shareholders reflect a 'true and fair' view of the financial results. What is 'true and fair' is a contentious problem for accountants. Nevertheless, what is evidently neither true nor fair rarely avoids comment.

e as a tax base

The tendency of most governments to take a substantial share of corporate income in the form of taxation means that the basis on which corporate tax is assessed is critically important to shareholders and management. Although taxation legislation does not define 'income', it does specify what is taxable and what is deductible in arriving at a measure of taxable income. Much litigation in this area has revolved around the meaning of words, but the taxation authorities accept accounting profit as the base from which to assess taxable profit.

ne as a guide to creditworthiness

A firm's ability to obtain credit finance depends on its financial status and its current and future income prospects. For this reason, credit institutions and banks require assurances of a firm's ability to repay loans out of future income and look upon current income levels as a guide in this respect.

me as a guide to socio-economic decisions

A wide range of decisions take into account the levels of corporate income. Thus, price increases tend increasingly to be justified in terms of income levels, and wage-bargaining procedures usually involve appeals by both sides to their effects on corporate income. Government economic policies are guided by levels of corporate income as one of the key economic indicators.

come as a guide to dividend policy

The distinction between capital and income is central to the problem of deciding how much may be distributed to shareholders as dividends. A series of important legal cases have been concerned with the concept of capital maintenance, and rules have been established for the measurement of distributable income with a view to protecting the interests of creditors. Thus, there is a rule which provides that losses in the value of current assets should be made good, whereas in arriving at the measure of distributable income, there is no need to make good losses in the value of fixed assets.

Nowadays, however, dividend policy is directed towards establishing the proportion of current income which should be retained and the proportion which should be distributed. This is because companies expect to finance part of their investment needs from retained income.

Income concepts for financial reporting

The application of different accounting valuation concepts to asset valuation and income measurement offers a variety of alternative bases for drawing up financial reports. In this part, we examine the implications of reporting to shareholders on the basis of the six alternative accounting valuation concepts listed in the introduction to this part, namely historical cost, present value, current purchasing power, replacement cost, net realizable value and current value.

Two criteria – relevance and feasibility – are highly significant in this regard. The stewardship concept of financial reporting is identified with historical cost accounting. This concept focuses on safeguarding assets rather than on presenting measurements useful for decision making. Clearly, financial reports should provide some safeguards against the misuse of assets by management, but they should also provide measurements to shareholders indicative of the efficiency with which assets have been employed. The latter type of measurement is relevent for decision making by shareholders and investors. It has become apparent that when applying the criterion of relevance to users' information needs, historical cost measurements fail to satisfy those needs. Feasibility embraces such aspects of the measurement problem as objectivity and ease of understanding, as well as considerations of costs of implementation.

Unfortunately, the selection of accounting measurements on the basis of the two criteria of relevance and feasibility does not rely on a simple set of accept/reject decision rules. To some extent each measurement currently available meets both criteria, but meets them at different levels of quality. For example, an accounting method which utilizes a measurement which scores highly for relevance may not score well for feasibility.

A second problem which will be examined in this part stems from alternative definitions of capital maintenance. There is some controversy about the manner in which concepts of capital maintenance may be made operational for financial reporting purposes. For example, the debate which followed the Sandilands Report illustrates that the operating capacity concept of capital maintenance does not immediately suggest agreement about the choice of an accounting valuation system which would satisfy the objectives of such a concept.

Summary

- The purpose of this chapter was to examine the implications for financial reporting of three concepts – capital, value and income. Two meanings may be attached to the concept of capital. First, capital may be seen as the totality of enterprise assets which give rise to income. Second, capital may be seen as the investment made by shareholders in the equity of the enterprise and from which they expect to derive income in the form of dividends. Investors are concerned not only with the interdependence