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*Income as an accounting evaluation  
of company operating efficiency*

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Dochód jako ocena rachunkowa efektywności operacyjnej spółki

**Key words:** income, profit, financial reporting, company operating efficiency

**Slowa kluczowe:** dochód, zysk, sprawozdawczość finansowa, efektywność operacyjna spółki

## Introduction

Income of companies is one of the most important indices of their operating efficiency objectively determining its priority role among the indicators expressing financial interests of many entities of the market economy. It is the amount of income that is the relevant information inducing them to make certain managerial decisions on the activity of income generating economic agent. Such concern with income defines it as one of the main objects of accounting and necessity of informing general public about its value determines one of the purposes of financial reporting preparation and presentation.

However, the imperfection of accounting methodology, particularly in the evaluation of company performance and their financial and property status, has resulted in leveling by financial reporting its role as a tool for market entity information support and has led to the demand for other, alternative for reporting, procedures to determine the operating efficiency and economic potential of the enterprises. The use of such alternative procedures, which have not been clearly formalized and publicly opened (available), gave, as a rule, the subjective overestimated results in the evaluation of

both the potential and performance of companies, certainly baselessly stimulating the growth of markets and, according to the opinion of many experts, has become one of the main factors of the onset of the financial and economic crisis. As a result, the need for return to the formal instruments of information support of public character, i. e. the corporate financial reporting, has grown up in the society. However, such reporting must gain a qualitatively new format, in particular, with respect to representations of the position and performance results of the companies and among others requires the development of a conceptual framework of income accounting interpretation.

## **1. Conceptual framework of income in the accounting**

Income is a multifarious (multidimensional) economic category in accounting science, and its content in various accounting theories, concepts or paradigms can be interpreted in different ways. Scientists E.S. Hendriksen and M.F. Van Breda, exploring the category of income in accounting, apply scientific approaches to the description of accounting as a language of business – pragmatic, semantical and syntactical [Eldon S. Hendriksen, Michael F. Van Breda, 2000, pp. 205–215].

A pragmatic approach gives the possibility to find out how the information on income affects its users. This approach involves the study of understanding the essence of income by various groups of information users taking into account their information needs. The main users of the information on the company income are: founders, investors, shareholders, top management, employees and the state, which have a direct financial interest which implies the distribution of income, as well as creditors, trade unions, non-governmental and other organizations with an indirect financial interest, which appears in the possibility of providing a high level of financial stability and solvency of the company that ensures its further activity, etc.

Investors and shareholders are primarily concerned with the size of their return on invested capital, including net income and earnings per share. For top management both the information on net income and the amount of earnings per share has a significant interest, since it defines the investment attractiveness of the company, as well as the information about the amount of operating income as a measure of main activity efficiency that provides continued existence and development of the company. Employees are interested in the amount of income that is directed to replenish the payroll (for bonuses or other incentive payments), pensions, etc. The State is primarily interested in the part of income that is paid to the budget in the form of certain tax, although its interest in the profitability of company functioning can be caused by many other factors (successful performance of individual companies is the key to social and economic welfare of the society, etc.).

Mainly, requests of users who have direct financial interest in the company income affect the formation of accounting data about it. However, the list of those users is not well-defined and in different accounting concepts of income it may include only the

owners (proprietary theory) and a wide range of stakeholders – investors, creditors, state (enterprise theory).

A semantic approach allows us to explore the meaning of income as an economic category. From the financial and economic point of view income reflects the additional value of invested capital. Thus, the definition of its contents should be done in the context of accounting interpreting category of capital.

From the position of impact of composition and structure of invested company capital on the essence of income in the accounting reflection of its formation and distribution, scientists distinguish different theoretical concepts:

- proprietary theory;
- entity theory;
- residual equity theory;
- enterprise theory;
- fund theory [Eldon S. Hendriksen, Michael F. Van Breda, 2000, pp. 480–486].

According to the proprietary theory, all assets of the enterprise with the deduction of liabilities are considered to be the proprietorship of its founder and reflect the cost of invested capital. Thus, any increase in invested capital (property) is identified as income of enterprise owner.

According to the entity theory company operation is considered separately from its owners, and all its capital – as contributed. From the enterprise viewpoint it is of no importance who invested the capital – the shareholders (equity) or the creditors (debt capital), – all of them are regarded as investors, but with different levels of claiming priority for income or assets [Eldon S. Hendriksen, Michael F. Van Breda, 2000, p. 226]. Net income in entity theory is identified as a surplus of equity augmentation after deducting payments for debt capital (interest on loans) and tax. However, this theory considers the interest on loans not as expenses but as distribution of corporate income [Eldon S. Hendriksen, Michael F. Van Breda, 2000, p. 482].

Residual equity theory illustrates the relationship among various stakeholders of the company capital. It is focused on conceptual baseline of information formation on financial and property status and operating efficiency of the company for holders of ordinary shares. Therefore, the main relevant indicator of income in this theory is the net income after paying interest on loans, income tax and dividends on preferred shares.

According to the enterprise theory, each company is a social institution the activity of which is to meet the interests of many social groups – shareholders, creditors, employees, customers, public authorities, public etc. According to E.S. Hendriksen and M.F. Van Breda, the best approach for income of such a company interpretation is the concept of value added which provides its identification as cumulative payments to shareholders (dividends), creditors (interest), employees (wages), government (taxes) and retained earnings [Eldon S. Hendriksen, Michael F. Van Breda, 2000, p. 485].

Under the fund theory the enterprise owners are not taken into account and equity is considered as a system of certain legal and financial restrictions on the use of

assets. Accordingly, the distribution of income is made by pre-defined criteria based on the placed externally (by owners, creditors or state) limitations.

Thus, the interpretation of income nature depends on the characteristics of the subject which generates the income (legal organizational form of the company or enterprise and scope of their activities, etc.), as well as on the subject who is interested in income (shareholders, creditors, employees, state, public, etc.).

Formally, the format of financial reporting, stipulated by both Ukrainian and international standards (IFRS), includes if not directly described above income indicators, then their individual elements, the integration of which allows to get the required income value (as, for example, the amount of value added is not given as aggregate indicator but there is information on labour costs and social security, income taxes, interest paid and dividends). But in practice the accounting definition of income is rather subjective. Differences between economic and accounting income provide the opportunity to understand a syntactic approach in its study.

A syntactic approach to the study of income in accounting involves the analysis of methods of its determination. The easiest way to formalize income reflects the difference of the company revenues and expenses. However, the economic nature of income is much more complicated: «the term «income» equally refers to the surplus of net assets at the end of the reporting period over the net assets, which were at the disposal of the company at the beginning of the reporting period. ... income remains one of the indicators that are the most difficult to define objectively» [J. Sutherland, D. Canwell, 2005, p. 235].

Method of income accounting is based on certain principles, assumptions, constraints or techniques which are formulated as a result of certain agreements between the representatives of the professional accounting community, and as pointed out by the scientists, often do not have matches in real economic life [Eldon S. Hendriksen, Michael F. Van Breda, 2000, p. 205]. These principles, in particular, include the accrual basis of accounting, which is the base for most national and international (IFRS) accounting regulations or principle imparity (expectation of possible losses) provided by the German Commercial Code [Jörg Baetge, 2000, p. 61]. As a result, the accounting income rather subjectively reflects the real performance of the company and is the subject of severe criticism by various experts and scientists.

In contrast, economic income, unlike accounting, does not depend on various principles or rules (especially on their possible changes), which increases the level of its objectivity. However, it is very difficult to determine the economic income from the systematic activity in the short term, especially for a single reporting period, if possible at all, that, in the end, has necessitated the formulation of certain principles and rules of income assessment in accounting.

The choice of basic capital concept, which underlies composition of the financial reporting format and accounting methodology, significantly affects the method of income determination. There are two basic concepts of capital maintenance – physical and financial. Under the financial concept of capital maintenance, income is earned

only if the financial (or money) amount of net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period after the excluding of any payments to owners or owners' contributions during this period. However, according to the physical concept of capital maintenance, income is recognized if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period after the excluding of any payments to owners and owners' contributions during this period [Conceptual Framework].

The concept of financial capital maintenance is aimed at evaluating the current financial performance of the company, while the concept of physical capital maintenance – at objective representation of the financial and property status. Impossibility of simultaneous application of both concepts has led to the problem of methodological dualism in assets evaluation.

Thus, the analysis of theoretical approaches to the studies of income nature in accounting shows that from the standpoint of efficiency and financial-economic status of the company representation in its statements, accounting income serves as equity regulative tool, reflecting the increase of its amount for the reporting period. The same opinion is held by many other scientists of accounting domain. In particular, I.J. Yaremko argues that “income, as well as loss does not form separate values but the related increase (decrease) of property and capital.” Moreover, the income (retained earnings) that is presented in balance sheet, he offers to term “profitable capital” that “more accurately reflects the performance results of the economic unit in the post-industrial economy and global capital linking” [Яремко І.Й., 2002, pp. 67–68]. Finally, in the fundamental scientific work (treatise) for accountants “Details of Calculation and Recording” Luca Pacioli defines the regulatory function for the income accounting [Пачоли Л., 2001].

## **2. Problems of income representation in financial reporting of public companies**

Multidirectional interests of the market economy entities to the performance results of the companies lead to diversity of their information requests which are difficult to meet by the single information tool – financial reporting. As a result, the modern format of financial reporting is formed on a compromise basis, but it cannot fully satisfy information needs of any group of its users.

The financial reporting conceptual framework defines as its main users existing and potential investors, lenders and other creditors whose decisions to purchase, sell or hold equity instruments and debt instruments or provide loans depend on the income that they expect to gain from investing in these instruments [Conceptual Framework]. Assumptions laid down by the conceptual framework that income forecast of investors

is based primarily on their evaluation of net future cash flows, create the conditions for the application of the financial capital concept in the financial reporting preparation.

The financial reporting conceptual framework focusing on information requests of investors and creditors led to the shift of accounting models towards microeconomic priorities at the expense of stability. That requires reinterpretation of qualitative aspects of accounting methodologies.

Current regulations of financial reporting, in particular GAAP, have been widely criticized for excessive orientation to income. According to experts, market entities in evaluating financial results are more and more oriented on cash (money) inflows but not on incomes [Samuel A. DiPiazza Jr., Robert G. Eccles, 2003, p. 57]. Moreover, taking into account market focusing on net income and earnings per share indicators, GAAP standards (eventually the same as other international regulations – IFRS) contribute to “the game in income” due to the possibility of income alignment between reporting periods.

Information alignment in financial reporting is necessary to create for potential investors a good “picture” of financial and economic status, on the basis of which forecasts of stable dividends will be made. That, as a result, should lead to the increase in stock price. However, such information alignment by accounting methods to ensure uniform trend of profitability indices, in our opinion, was one of the reasons for market refusal from reporting as a tool for information support of investment decision making.

## Conclusions

Thus, the amount of income, presented in financial reporting should reflect the increase in company equity and should be recognized only when such increase has actually occurred. Therefore, the recognition and evaluation of revenues and expenses is only a method (way) of calculating income, and the methodology is based on the principles and assumptions that reflect the “force of gravity” to the relevant concept of capital maintenance – financial or physical.

The analysis of modern approaches to the evaluation of income in accounting has showed the existence of alternative accounting methods, the choice of which directly affects the amount of the company's income. It is worthwhile to agree with the opinion that “accounting and analysis in many respects became a significant factor in ensuring the economic well-being of business residents, sometimes directly influencing their final destiny” [Белоусов А.И., 2011, p. 5]. However, the existence of such methods can induce top management of companies to changes in accounting policy for “embellishment” or “alignment” of their performance indicators in financial reporting, which is seen by some experts even as the manipulation of the market entity opinions and is recognized as the biggest drawback of accounting reporting as a formalized source of information support. However, other alternative reporting

methods of representation of company operating efficiency do not provide results with sufficient level of objectivity and transparency.

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## Income as accounting evaluation of company operating efficiency

Theoretical and conceptual approaches to defining the essence of income in the science of accounting are considered, methodological basis to reflect income in the financial reporting are analyzed, and the main problems of objectivity representation income statements of public companies are outlined in the article.

## Dochód jako rachunkowa ocena efektywności operacyjnej spółki

Autor prezentuje dochód jako wielowymiarową kategorię ekonomiczną. Analizuje teoretyczne koncepcje w zakresie wpływu struktury zainwestowanego kapitału na wielkość dochodów, na ich powstawanie i dystrybucję. W artykule została zaprezentowana koncepcja wpływu kapitału finansowego na ocenę bieżących wyników finansowych spółki oraz koncepcję kapitału rzeczowego. Autor stwierdza, iż przedsiębiorstwa traktują dochody księgowe jako narzędzie odzwierciedlające wzrost wartości podmiotu w danym okresie sprawozdawczym.