

THE CONCEPT OF PROFIT IN
ECONOMICS AND ACCOUNTING

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This Thesis is my original work, and has not been presented
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PREFACE

The purpose of this thesis is to point out the difference in the usage of the word 'profit' in Economics and Accounting. An effort has also been made to establish the relationship between 'economic profit' and 'accounting profit', and take up some of the issues related to profit. It is, however, admitted that the concept of profit in two different fields cannot be dealt with fully in a thesis of this volume.

A secondary purpose of the thesis is to outline an alternative measure of profit to that currently offered in financial reports. In attempting this secondary task, reference has been made to the economic concepts of Income and Value. The Economist does not like the Accountant consider income and profit to be synonymous. I call the task a secondary one because numerous authors, more able and far seeing than myself have already formulated the ideas expressed in chapter 5 of the thesis. To them, I gratefully acknowledge my debt and readily apologise for any misrepresentations.

I am most thankful to my Thesis Advisers, Mr. N.C.W. Gibbs and Professor Fields without whose help and guidance it would not have been possible for me to complete the thesis. My thanks are again due to Mr. N.C.W. Gibbs who

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SALIM HERRAJ

CHAPTER ONEINTRODUCTION1.1 SCOPE OF THE STUDY¹

It is widely agreed that economics and accountancy are related. The nature of the relationship is less clear. There are nonetheless important differences between them. The typical accountant is a pragmatist. His job is to help to solve specific problems in particular circumstances for a specified person or group of persons. To help him to do this he has specially the long established technique of double-entry book-keeping. He is subject to the limitations of the practical man. The rate of technical change is often slow and new problems cannot be answered satisfactorily until a variety of methodological adjustments has been made by a multitude of practitioners. On the other hand, his solutions and work must satisfy the critical survey from day to day of those for whom they are prepared, whether managers, shareholders, or other interested parties.

In contrast, the typical economist is fundamentally a theorist. He is concerned to design a logical structure, or to formulate a model, which will explain the general run of economic events. Economics is concerned as much, if not more, with the long-term secondary effects of particular policy changes as with their short-term primary results. The emphasis is on aggregates, whether in dealing with market situations or with general income and employment problems. The economist may therefore need to pass judgement on the ends of economic activity, sometimes directly and sometimes in the framework of assumptions

which he devises (for example, that the object of the businessman is to maximize profits). The accountant executes his duties inside a particular organisation, small or large, according to terms of reference devised specifically for him. He judges only the means, rarely the end of economic activity.

Every branch of study has its own list of terminology, and often the usage of the terms in that particular field is quite different from their common usage. Economics and Accounting are no exceptions to this. In Economics, we have terms like goods, wealth, utility, value, etc., while in Accounting, we have terms such as assets, liabilities, capital, etc. These terms are used to denote specific meanings in their respective fields, while they may have different connotations in other fields of studies.

There are certain terms which are used in Economics as well as in Accounting, yet they are used for different concepts. The concept of rent in Economics for example is different from its concept in Accounting. The students, who for the first time read Economics find themselves completely upset when they discover that rent in Economics does not mean the same as in our day-to-day conversation. They are still more confused when they read that rent in Economics does not enter into cost-price relationship. In the beginning, they are not inclined to accept this. They come out with arguments against this. Generally, they argue like this: 'A hawkser generally sells goods at cheaper rates because he has to pay no rent. On the

other hand, a shop-keeper in a fancy shopping centre charges higher price as he has to pay rent for the shop and usually the rent happens to be a handsome amount. As such, rent enters, and forms a part of the commodity'. Whether rent is or is not a price-determining cost, depends on the view point from which it is looked upon. From an individual's point of view, rent does enter into the cost of production. An individual has to pay rent to the landlord. If the land is self-owned, the residual must at least equal the rent which the individual can get by letting out the land on rent. Otherwise it will not be worthwhile to plough the land. From the society's point of view, rent does not enter into the cost of production. Since the supply of land is limited by nature, it would be supplied to the society even at the lowest price.² In order to avoid confusion, one can use the words 'contractual rent' and 'Economic rent'.

The term 'profit' is also used in Economics and Accounting. But since it denotes different meanings in Economics and Accounting, it is generally a source of confusion. Also it is very important to see that the economist does not, like the accountant, consider income and profits to be synonymous. In its most general sense, economic income consists of scarce services which "... proceed, ultimately, from material objects, but under no circumstances are material things income; these belong to a wholly distinct, though related category".³ Profit is regarded as one of the distributive shares of income together with rent, wages, and interest. The main purpose of this thesis

is to show separately the concept of profit in Economics and Accounting (note the word profit), and then try to show the relationship between the two concepts. A secondary purpose of the thesis is to outline an alternative measure of profit to that currently offered in financial reports. In attempting this secondary task, we shall also refer to the economic concepts of income and value.

1.2 PROFIT IN ECONOMICS

The first assumption of economic theory which we usually come across is the idea that producers attempt to maximise profits. On this assumption, *inter alia*, rests the whole structure of the economist's theory of the firm, that is, the body of analysis which investigates the general patterns of price determination and resource allocation under specified assumptions as to market conditions.

Samuelson defines profits as "what you have left over from the sale of the product after you have paid the other factor costs from revenues".⁴ This accords with the general accounting technique. But the suggestion that profit is a factor cost (that is, an expense) is foreign to most contemporary accounting thought.

Samuelson later distinguishes four separate categories of profit.⁵ The first is an allowance for wages, rent and interest payable to the owners for the factor input services

provided by them. It is towards this level that economic theory suggests that profits will move in the long run under conditions of pure and perfect competition.

The other three categories arise from the absence of the very specialized conditions of pure and perfect competition (such as perfect knowledge of all the market forces affecting supply and demand on the part of all the buyers and sellers in the market, no one of whom alone can influence the market price). In other words, they are caused by imperfections in the market structure. These categories are:

- (a) Temporary higher earnings resulting from some innovation in methods or product, that is, a reward for the successful execution of the entrepreneurial function;
- (b) The result of the unforeseeable discrepancies between businesses caused by the existence of uncertainty as to the pattern of future events: that is, a payment for bearing risk. It is a reward for operation in an industry from which others are repelled by uncertainty. Once it has been earned, this element of profit is more likely to persist in the long run than is category (a) above;
- (c) The additional return which accrues to a firm holding a monopoly position, that is, monopoly profit, or "quasi rent".

This analysis of profit, as the payment for factor input services or as the resultant of imperfections in the market structure, is not generally employed in the accounting reports. These normally accept the market situation and impute the profits earned wholly to actions of the company's own management. For example, the analysis of profit may be by product or division, or may concern itself with the main flows of revenue or expense. This is the fundamental difference of approach. It illustrates the accountant's prime concern with short term results, during the working out of which market conditions are unlikely to change significantly. In contrast, economic theory tries to describe how a market situation changes in the long run.

1.2.1 The Basis of Cost Measurement

On what basis do economists calculate the factor costs which must be deducted from revenue in order to find profit?

In the long run profits earned under conditions of pure and perfect competition tend towards the level of Samuelson's first category, an allowance for factor input. In other words, long run price equals long run costs (including these "normal profits"). Long run production plans are determined by expectations of future revenues. If the entrepreneur is to make a rational choice of plan he must compare the costs of all alternative ways of providing the services which he needs. He needs data in constant terms based on current price levels,

even though some of his expenditure (for example, on plant) may have been incurred when prices differed. In other words, he must try to discover the cost of keeping and using his existing resources, rather than offsetting against revenues part of their purchase price.

Furthermore, in planning his activities the entrepreneur will wish to know the amount of his surplus after maintaining his capital intact. A measure of capital, and therefore of costs, in historic monetary terms is unsatisfactory as soon as prices change, whether this change takes the form of a change in the general price level or a change in the relative prices of different things. The essence of prices is that they are simply a convenient way of expressing relative desires for different things, and they are therefore of constant changing. There would be no profit until capital has been maintained in terms of productive power. An approximation to this can be achieved by expressing capital, and therefore costs, in terms of current prices.

The accountancy profession has generally not yet endorsed this principle of current cost. The accountants have preferred to measure the cost of a period as an allocation of an appropriate amount of the expenditure that has already been incurred in order to try to earn revenue. Such historic cost measurements are claimed to be more objective, and more susceptible to practical measurement and verification. Some might even claim

that such figures are more useful to the manager or investor.

So we see that the economist advocates the use of current costs as an index of the real sacrifice made to earn revenue, while most accountants still adhere to historic cost measurement.

In short, profit in economics is generally understood to mean the difference between the revenue and expenses, or to put it differently, the difference between the total sale-proceeds obtained by a businessman, and the total costs of production. This is usually referred to as gross profit. In order to arrive at the figure of net profit, the following must be deducted from the gross profit:

- (i) rent of self-owned land and difference between the economic rent and contracted rent in respect of other lands;
- (ii) interest on capital invested by the owner or owners, as the case may be, and
- (iii) remuneration of the owner(s).

The elements of profit are as under:

- (i) reward for risk-taking and uncertainty bearing;
- (ii) reward for enterprise and innovation;
- (iii) return due to monopoly or imperfect competition; and
- (iv) gains due to fortuitous and unexpected happenings.

There are many theories which explain the nature of profit. The theories of profit have undergone tremendous changes with the passage of time. Walker's Rent Theory of Profit has been developed on the lines of Ricardian Theory of Rent. Taussig and Davenport's Wages Theory of Profit maintains that profit is similar to wages. Hawley's Risk bearing Theory of Profit lays down that profit is the reward for risk-bearing by the entrepreneur. Knight's Uncertainty-bearing Theory of Profit maintains that profit is the reward for the uncertainty bearing function of the entrepreneur. Clark's Dynamic Theory of Profit maintains that profits arise solely due to dynamic changes and that profits would tend to disappear in the static state. And lastly Chapman and Edgeworth's Marginal Productivity Theory of Profit states that the remuneration of entrepreneurs is determined like any other factor of production, by the marginal net product of the factor organisation. The defect of all of these theories is that each of them lays emphasis on only one aspect of the functions of the entrepreneur to the neglect of the others. The entrepreneur performs not one but many

functions. None of the theories is, as such adequate to explain the nature of profit.

The Socialist School has described profit as 'legalized robbery'. According to Karl Marx, all value is due to labour and must go to labour. A part of this value is usurped by the capitalists in the shape of profits which is unjustified.

1.3 PROFIT IN ACCOUNTING

A main function of accounting is to provide information to managers or investor on the profitability, resources and financial arrangements of the firm which they manage or own. Management can be defined as the utilization over time of resources of labour, equipment, materials, and a variety of services in order to achieve a desired return. The intended return may be growth, profit, customer service, prestige and reputation, the security of the existing management, or perhaps the provision of a social service, or a varying mixture of these and other objectives, any two of which may, of course conflict. These objectives can all be interpreted in several ways. For example, does growth mean more sales, a bigger share of the market, more production, more capital investment, more employees, or more profit? Does profit mean an absolute sum of money, or a rate of return on capital?

Most accounting reports are in some way related to the measurement of the profit which is being earned. Some measure of

profit is thus widely assumed to be the dominant objective of at least the privately owned commercial concern. Management then becomes the investment of resources through time, primarily to earn profit. This is exactly the problem which faces the investor in the business. Fundamentally, the nature of the accounting information needed by both is the same. Both need a comparison of the investment with the return it produces, for all reasonable alternative courses of action.

Many of the problems of accounting reporting arise because of the resulting need to analyze the activities of a business operating in a time continuum, and then to attempt to allocate their results to clearly segregated accounting periods. The standard presentation of this information for a company as a whole is, of course, in the profit and loss account and the balance sheet. The profit and loss account purports to show in summary form the sources and amounts of revenue flows over a period of time, the objects and amounts of the expenditure made to earn that revenue and the objects to which the resulting balance of profit is appropriated. The balance sheet lists the resources owned, valued usually at purchase price less an amount for amortization where this is appropriate, and the sources from which this expenditure was financed. If it is thought that a measure of the percentage return on capital employed is useful, a figure can readily be calculated and analyzed from these statements.

In Accounting, gross profit is the difference between revenue from sales and the cost of goods sold. In order to arrive at the figures of net profit, the operating expenses which consist of selling and general and administrative expenses, are deducted from the figure of gross-profit. In Accounting, the business and the owner(s) are treated as two separate things. Accountants deal primarily with three general kinds of business entities: the individual proprietorship, the partnership and the corporation.

In a sole-trading concern, there is only one owner. He receives all the profits and bears all the losses. The balance of profit or loss shown by the Profit and Loss Statement is, as such, transferred to the capital account of the sole-trader. The drawings of the sole-trader are treated as the withdrawal of anticipated profits and they are not shown among the expenses of the business.

In a partnership firm, many adjustments are generally needed before the figure of profit or loss as shown by the Profit and Loss Statement is transferred to the capital accounts of the partners. These adjustments depend on the provisions of the partnership deed. Provisions regarding salaries of the partners, interest on capital invested by the partners, interest on drawings of the partners, etc., are usually found in the Partnership Deed. A clause regarding profit and loss sharing ratio is also generally incorporated in the Deed. In the absence

of such a clause, profits and losses are shared equally by the partners irrespective of their individual contribution towards the capital of the partnership and their services to the business. In a partnership firm, the profit and loss shown by the Profit and Loss Statement is transferred to a new account called the Profit and Loss Appropriation Account, where all the adjustments are made, and the balance of profit or loss shown by the Profit and Loss Appropriation Account is distributed amongst the partners in their profit and loss sharing ratio.

Unlike sole-trading concerns and partnership firms, a Joint Stock Company possesses separate legal entity. The profits made by a company during an accounting period are transferred to the owners i.e. the shareholders in the form of dividends. The Directors of the company have full authority either to declare dividends or not. The directors are, however, restricted in their power to declare dividends by some legal and contractual obligations. Besides, they do see whether financially, dividend declaration will create problems or not (e.g. the liquidity problem). The shareholders cannot claim dividends as a right if the directors do not deem it fit to declare dividends. The amount proposed by the directors as dividends cannot be increased by the shareholders in the annual general meeting. The directors are almost always authorized to withhold whole of the earnings or part of it from distribution to the shareholders as dividends. The various reserves and provisions that the directors create, depend on the contractual obligations as well as on the discretion

of the Board of Directors. Generally there are many types of shares in a company. The rights and liabilities of each type of shareholder differ. In some types of shares, the percentage of dividends is fixed while in other types, it is not.

The earnings of the company are transferred from the Profit and Loss Statement to the Profit and Loss Appropriation Statement where various reserves, provisions and funds are created. Besides, dividends are declared out of the earnings. The balance of unappropriated profit remaining after all these, is carried on the books of account as revenue reserve.

1.4 INCREASED NET WORTH THEORY

An alternative way of measuring the profit of a period is to calculate the increment in the value of the resources held. In other words, profit is the growth in net worth over a period.

This method of measurement raises two main problems. The first is the need to make appropriate adjustments to the closing net worth figure in respect of changes in the capital invested in the concern. This should normally involve only adding back dividends and repayments of capital, and deducting the proceeds of new issues.

The second problem is far more difficult to solve. How is one to measure the net worth of the firm? In other words,

what should be one's concept of value? If it is accepted that the earning of profit is the primary object of a commercial organisation, then that organisation has value primarily because it is expected to be capable of providing revenue to the valuer in the future. This revenue may take various forms, for example, trading income, capital rights, or a price earned on realisation. The net worth of the concern at any point of time is the present value of these future revenue flows derived from its assets and computed at an expected interest rate. The profit of a period is then the difference between the present values of the revenue expectations of the concern at the beginning and at the end of the period.

Ivar Kreuger, the Swedish Match King, expressed the same view in a more general way, when he said:

".....And someday people will realize that every balance sheet is wrong because it does not contain anything but figures. The real strengths and weaknesses of an enterprises lie in the plans." (6)

This is a much broader approach to profit measurement than the customary calculation of revenue minus cost, however cost is defined.

The literature of economics recognises that there are important problems in measuring the net worth of a business.

First, the future cash flows must be estimated as far ahead as possible. This is straightforward in the case of an annuity, or a fixed interest security redeemable on known terms at a known date; the outcome of such transactions is certain. But the outcome of the activities of a commercial trading or manufacturing concern, operating in an uncertain market situation full of possibilities and probabilities, cannot be accurately foretold. The further into the future the forecast reaches, the less certain it becomes. Also, the difficulty of attributing revenues and costs to particular assets, or potential assets, makes this application even more difficult.

Second, an interest rate must be chosen at which to discount the estimated cash flows. This problem is the one of determining the cost of capital to the firm. This might be one of the various market rates for borrowing capital, according to the method of financing adopted; or some sort of "commercial rate of return"; or the opportunity rate which is foregone by not making the best known alternative investment of funds.

These are among the many problems which concerned J.R. Hicks when he discussed income in his book "Value and Capital".⁷

Hicks defines income as "the maximum amount that a man can consume in a week and still expect to be as well off at the

end of the period as at the beginning". In other words, it is what a man earns over and above the amount needed to maintain his stock of capital. He then discusses the meaning of capital, or 'well-offness'. If it means the present value of anticipated future net receipts, as described above, the amount of the valuation will be altered by a change in the firm's cost of capital, or discount rate. This can be allowed for by refining the earlier definition, so that income becomes "the maximum amount that can be spent in this period which will allow the same amount to be spent in each future period". But this is inadequate if prices change, since a different quantity of goods can then be purchased with the same amount of money. The definition must be further refined to take account of this. Income then becomes "the maximum amount that can be spent in a week which will allow the same amount to be spent in real terms in each future period". But what are 'real terms'? Over time, a variety of goods and services is consumed and replaced with others. In order to equate these, it is necessary to think of 'equivalent satisfactions'. That is, income becomes the maximum amount that can be consumed in a week which will allow equivalent satisfactions to be enjoyed in each future period". And this is, if anything, a less precise statement than the first definition, to which Hicks returns for want of anything better. In other words profit is measured as the growth in capital value over time, if capital value is defined as the present value of expected future net benefits.⁸

This discussion demonstrates the high degree of estimation inherent in profit measurement. Hicks then goes on to suggest that a measure of profit can be only a rough approximation of progress, which is used by the businessman to help him to pilot himself through the bewildering changes of situation which face him. He considered it less suitable for use in designing a logical framework of economic theory.

1.5 THE CONVENTIONS OF PROFIT MEASUREMENT IN ACCOUNTING

This element of approximation is central to profit measurement. Yet profit and loss accounts and balance sheets are detailed and balanced down to the last cent. How can such precise data be produced?

The accountant's usual method of measuring profit is to compare the revenue earned in a period with the expenditure made to earn it. Therefore, he must first measure the revenue flows and allocate them to the appropriate periods. He must then measure the flows of expenditure and allocate them to the periods in which they are deemed to produced revenue. The measure of revenue is the value of sales effected for either cash or a legally enforceable debt. Costs are the expenses incurred in buying, making, storing, selling, and distributing the products which have been sold. Unrealized gains are not recognised.

A distinction is made between "capital" expenditure (or receipts) and "revenue" expenditure or (receipts). Capital

expenditures are those which are thought to be likely to produce benefits lasting more than a year beyond the accounting period in which they are made. Such expenditure is not charged against revenue in the period in which it is incurred. Nor is revenue accruing from the sale of the object of such capital expenditure included in the measurement of profit, even if it has been realized as money. However, capital expenditure is written off against revenue during the periods when its object is deemed to be likely to produce revenue. This amortization charge may be calculated by any of the several widely accepted methods (straight-line, diminishing balance, etc.). It becomes a cost of these later periods.

When comparing the return from an investment with the cost incurred in earning it, accountants have usually worked with historic costs. The conventions of (a) realized revenue and (b) historic cost reduce the element of estimation in profit measurement below that usual in the current cost and present value methods of the economists, but they do not eliminate it. Indeed, bias is often introduced by following a deliberately prudent or conservative policy. The well-known general tendencies are:

- (1) to understate the revenue and to overstate the costs of a period whenever there is doubt, often by the simple technique of delaying the recognition of revenue and advancing the recognition of expense, and

- (ii) to advise the acceptance of a minimax policy, that is, the pursuit of those activities which seem likely to minimise the maximum loss that could conceivably occur.

As accountants well know, conventional accounting reports are precise simply because once the necessary estimates have been made, the technique of double-entry book-keeping ensures a neatly checked answer. Many people both within the accounting profession and outside it, have expressed dissatisfaction with the convention of historic cost, and less frequently with the convention of realized revenue.

The expenditure which has been made, but not written off against the revenue of a period, forms the basis of the accountant's valuation of the assets employed in the business and is carried forward to the next period. For example, stocks are usually valued at their estimated cost of production or purchase. Similarly, equipment is valued at its acquisition price, usually less an amount for amortisation. These valuations are summed, and liabilities are deducted, in order to find the shareholders' capital employed in the business. This will be equal to the sum total of the paid up share capital, the retained profits (as calculated by accounting conventions) and retained realized capital gains. It is possible to measure accounting profit by comparing this balance sheet figure of capital employed on successive occasions in the same manner as in the

calculation of increased net worth, allowing for dividends, capital withdrawal and capital introduced. But the answers must differ.

Some of the important differences between Net Worth and General Accounting Practice are:

- (i) measures of capital values and profit made according to the net worth theory look forward over time, as must a successful manager or investor, instead of generally backwards overtime, as does general accounting practice. An important effect of this is that gains, as well as losses, can be recognized before they are realized, i.e., at an earlier point in time than is the case in general accounting practice.
- (ii) net worth measurements are necessarily founded on subjective estimates, and not on completed exchange transactions. Although the effect of past transactions may strongly influence the estimates, as may evidence of current price levels, and although they should be made in accordance with defined procedures which are capable of assessment by an informed outsider, they are clearly subject to a greater degree of estimation than are historic cost measurements.

(iii) The estimates made are of the expected future cash flows, i.e., receipts and payments.

Accountants long ago rejected a receipts and payments accounts as a measure of short term profit.

In short, the increased net worth calculations are forward-looking, and take account of the whole structure of the business. Conventional accounting figures are historic, and usually include only past expenditure on tangible assets.

Economic theory suggests that the solution of management problems of an investment nature demands the use of current cost and return figures, built into a forward looking framework of present values. Many accounting reports may well be more helpful to their addressees, but as they have been customarily prepared, they offset against current revenues the cost of purchasing the investment (that is, its historic cost) and not the cost of keeping and using it (that is, its current cost).

Many of the conventions of accounting measurement were first developed in an earlier era of charge and discharge accounts, when the main object of accounting was to check on the stewardship of others who had to account for their expenditure of the moneys entrusted to them. Periodic profit computations were of little interest. For such purposes, accounting conventions are sound. They are less satisfactory for measuring business

profits and resources. The growing use of replacement values of accounts, and the acceptance of present value calculations for such important purposes as company valuation and capital budgeting, indicates a volume of opinion in support of this contention.

1.6 ARRANGEMENT OF THE THESIS

The thesis has been divided into five parts:

- Part I: Introduction
- Part II: Economics
- Part III: Accounting
- Part IV: Valuation and Profit
- Part V: Conclusion

Part I, as the title suggests, introduces the thesis. Part II deals with the economic concept of profit. Part II consists of two chapters. In the first chapter, a general discussion of what is profit has been made, while in the second chapter important theories of profit have been described. Part III of the thesis discusses the accounting concept of profit. It consists of one chapter. In this part a general discussion of the accounting concept and measurement of profit has been undertaken. The accounting treatment of profits in sole-trading concerns, partnership firms, and joint-stock companies is also undertaken in this part. In talking about profits in joint-stock companies, we also take up some important legal decisions on profits. The

question of dividends has also been taken up. An appendix to this part consists of an actual case study in the Tanzanian environment. It shows the effect of the application of Section 7 (1) of the Companies (Regulation of dividends and Surpluses and Miscellaneous Provisions) Act, 1972, concerning limitation of Dividends, on a certain company in Tanzania - Simba Tours and Lodges Limited. Part IV of the thesis outlines an alternative measure of profit to that currently offered in financial reports. Part V of the thesis is the concluding part of the thesis. In this part, conclusions have been drawn. The relationship between accounting profit and economic profit has been established in this part of the thesis. Also, in this part, we have set forth some objectives of financial statements. In this part, we try to show that there is a close relationship between the alternative measure of profit and asset valuation which we have developed in part IV of the thesis, and the objectives of financial statements set forth in part V.

CHAPTER TWOWHAT IS MEANT BY PROFIT?2.1 WHAT IS PROFIT?

The answer to the question, what is Profit, has been given by persons from different professions - judges, auditors, accountants, economists, etc. Though all of them have defined the same thing - profits - yet their views do not tally.

On the legal side, one of the best definitions of profit is given by the court in the case of the Spanish Prospecting Company Limited (1911):¹

"The word profit has, in my opinion, a well defined meaning, and this meaning coincides with the fundamental conception of profits in general parlance, although in mercantile phraseology, the word may at times bear meanings indicated by the special context, which deviate in some respects from the fundamental signification. Profit implies a comparison between the state of a business at two specific dates, usually separated by an interval of an year. The fundamental meaning is the amount of gain made by the business during the year. This can be ascertained by a comparison of the assets of the business at the two dates.

.....If the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance, of course, being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.....The strict meaning of

the word 'profit' is rarely observed in drawing up the accounts of firms or companies.

.....Certain assumptions have become so customary in drawing up balance sheets and profit and loss accounts that it may almost be said to require special circumstances to induce parties to depart therefrom. For instance, it is usual to exclude gains and losses arising from causes not directly connected with the business of the company....The value assigned to trade buildings and plant is usually fixed according to an arbitrary rule by which they are originally taken at their actual cost and are assumed to have depreciated by a certain percentage each year, though it cannot be pretended that any such calculation necessarily gives their true value either in use or exchange.

.....It is better to under-rate than over-rate the profits, since it is impossible for you to see all the risks to which a business may in future be exposed....But though there is a wide field for variation of practice in these estimations of profit, this liberty ceases at once when the rights of third parties intervene....In the absence of certain stipulations to the contrary, 'profits', in cases where the rights of third parties come in, mean actual profits, and they must be calculated as closely as possible in accordance with the definition to which I have referred."

After a legal view point, it looks best to reproduce some of the definitions given by the accountants.²

Baker and Howell define it as follows:

"..... The actual net balance of gain realized by the financial operations of the undertaking in relation to which the scheme exists." (3)

Kohler and Morrison give the following simple definition of profit in the old unincorporated business:

"Profit, as used by the accountant, is the increase in the owner's investment resulting from the operation of a business over a period of time, and he originally does not distinguish between the positions attributable to capital invested and services performed by the owners." (4)

Kester talking in the backgrounds of developed corporations presents the following definition:

".....The term profit has been applied to those increments of value arising from whatever source, which flow from completed transactions with outsiders, as distinguished from the corporation's dealings with itself or its stockholders." (5)

Paton comes out with the following definition:

"Net business income or net revenue may be defined as the amount by which the equities of the proprietors and all others entitled to participate in income are enhanced as a result of successful operations." (6)

An American Institute's committee on the definition of earned surplus defined net profits as follows:

"Net profit, net income, and gains include profits from the disposition of any corporate asset (other than the corporation's own capital stock), and arise from transactions resulting in the acquisition of cash or of property which at the time of the receipt may ordinarily

be classified as, or converted into, a current asset; or from transactions in which the consideration received include the complete or partial discharge of a liability." (7)

What an auditor thinks about profit, will be illustrated by the following definition given by Montgomery:⁸

"If a public accountant were asked to define the term 'net income' he would probably reply that: 'net income of a business is the surplus remaining from the earnings after providing for all costs, expenses, and allowances for accrued or probable losses'".

Another view point which is not so much a definition as a description of profit, has been put forward by Littleton as under:⁹

"Net income then is shaped, as it were, by the interaction of the blades of a pair of shears, - revenue as one and cost as the other. It is obvious that both blades are necessary to produce the result, but their action is not necessarily equal. One blade may rest passively on the table while the other blade moves actively up and down under the power of the operator's fingers. The passive blade represents revenue - the element under little direct managerial control; the active blade represents costs - the element under a considerable managerial control in the process of producing net income."

The 1957 Revision of "Accounting and Reporting Standards for Corporate Financial Statements" defines profit (income) in this manner:

"The realized net income of an enterprise measures its effectiveness as an operating unit and is the change in its net assets arising out of (a) the excess or deficiency of revenue compared with related expired cost and (b) other gains or losses to the enterprise from sales, exchange, or other conversion of assets. Interest charges, income taxes, and true profit-sharing distributions are not determinants of enterprise net income. (10)

Aside from the implication that the change in net assets can be measured by a comparison of revenue with related costs, however, this statement does not add much beyond the discussion in 1938 by Sanders, Hatfield, and Moore:

- "(1) Income is the increment in wealth arising from the use of capital wealth, and from services rendered.
- (2) Income in the narrow sense is the owner's share of this increment. This is the income which it is sought to define as 'net income' in the income statement.

Thus it is convenient to think of capital as a store of wealth existing at any one time, and to think of income as the flow of increments in that wealth yielded by the activities of the business.

Additions to the wealth of the business resulting from further investments by the owner, or further contributions by lenders, are increases of capital and not income. Similarly restatements of the money value of the same capital goods, and actual increases in them, are increases in capital in the narrow sense, and are not income.

Income normally arises from the sale of goods or services for amounts greater than their cost." (11)

From the above definitions and descriptions, it will be evident that the term "profit" is generally understood to signify

the surplus which remains after the payment of rent, wages, interest on borrowed capital and other expenses. In other words, the profit is the difference between the sale proceeds and total expenses.

2.1.1 Gross and Net Profits

But speaking in economic terminology, we regard the above as gross profit. Gross profits include many such items which, as a matter of fact, should not be regarded as profit. Specifically speaking gross profits may include:

- (i) rent on land owned by the employer as well as the difference between economic and actual rent in respect of other lands. Since a person may not be paying the full economic rent for the land held by him, his profits are inflated to that extent.
- (ii) interest on capital invested by the owner: The interest on capital borrowed from outsiders is shown as an expense and deducted from the sale proceeds, but interest on capital brought in by the owner(s) is not usually determined. This should be done if net profit is to be arrived at.

- (iii) the remuneration of the entrepreneur:
- Since generally the remuneration of the entrepreneur is not shown as an expense, it is necessary to deduct this. The entrepreneur's remuneration for managing the concern is taken to be equal to the sum which he would have got had he been employed in some other concern. This should be shown as an operating expense as is done in the case of a Joint Stock Company. In any company, since the owners i.e. the shareholders and the managers are two separate groups, the remuneration of the managers is included in the operating expenses of the company. The profit remaining after the deduction of the above is called Net Profit.

2.1.2 Elements of Profit

There are four elements in Profit:

- (i) Reward for risk taking and uncertainty bearing:
 Since an entrepreneur assumes the risk of production, he gets some reward for risk taking and uncertainty bearing.
- (ii) Reward due to monopoly or monopolistic competition:
 Generally the price we pay for different commodities

is slightly more than what we would have paid had there been perfect competition. Due to monopolistic or semi-monopolistic position or imperfect competition, the manufacturer is able to charge higher prices. Moreover, perfect competitive conditions do not prevail in the market for factors of production. The manufacturer, finding himself in a better bargaining position, is able to pay less to factors of production in comparison to their contribution to the production of goods. For instance, due to the imperfect competition prevailing in the labour market, the manufacturer is in a position to exploit the situation and pay the labourers less than their marginal net products. The profits as such swell due to monopoly and imperfect competition.

- (iii) reward for enterprise and innovation: Manufacturers who are able to produce new commodities or new capital equipment, or can discover or borrow new processes, are generally in a position to manufacture commodities at cheaper rates. They are in a position to earn huge profits due to the above. Profits, as such, include remuneration for enterprise and innovation.

- (iv) Fortuitous gains: A sizeable part of the profits can be attributed to fortuitous happenings. A sudden shift in demand may push the prices to new heights. The quantity demanded may also increase. Such profits can only be attributed to good luck.

2.2 FOUR POINTS OF VIEW ABOUT PROFIT

As Samuelson has pointed out there are points of view about profit:¹²

- (1) First view is that profit is an implicit factor return or the earnings of self-employed factors. Profit may consist of the return to the owners for the capital supplied by them, wages to the owners for their services to the business, and rent return on self owned natural resources. This part of the profit may be called implicit interest, implicit rent and implicit wages.
- (2) Second view is that profit is the reward for enterprise and innovation. If the competition is perfect there will be no profits since all the factors of production will get what they produce. In other words the implicit returns to the labour and property supplied by owners would exactly swallow up all the profits reported. This is because owners would hire out their factors

on the market if they did not get equal rewards from using them in their own businesses. And also people who previously were hiring out their labour and property services would soon go into business for themselves if they knew they could earn more in that way.

Perfectly free entry of numerous competitors would, in a static world of perfect knowledge, bring price down to cost and squeeze out all profits above and beyond competitive wages, interest and rent. But the competition has never been perfect in the past and will never be so in the future. In this ever-changing economy, there is ample scope for people with enterprising nature to come out with new ventures, and for people with scientific brains to invent new things and design new machines or improve the existing processes. These lead to windfall of profits. As such profits contain an element of reward for enterprise and innovation. Usually, these profit earnings are temporary and are soon competed out of existence by rivals and imitators. But as one source of innovational profits is disappearing, another is being born. So these innovational profits will continue to exist.

- (3) Third view is that profit is the remuneration for risk and uncertainty. When a new industry is set up, its future is uncertain. No one can say with full assurance

that the commodities produced by the industry will be in demand. There is a risk that the industry may not be able to survive due to competition and lack of demand, etc. The persons who volunteer themselves to assume the risk and uncertainty are rewarded in the form of handsome profits. Sometimes there may even be losses. It must be pointed out that the rate of return must be more than the rate of return on safe investment like depositing the money with some bank. If it is not so, there will be no inducement for the people to bear risk and uncertainty.

- (4) Fourth view is that profit is a monopoly return. Due to monopolistic position, semi-monopolistic position and imperfect competition, a manufacturer is in a position to charge higher prices for his products as well as pay to the factors of production less than their contribution to the production. Profits, as such, contain some element of return due to monopoly.

The view points presented by Samuelson will be clearer when we take up the different theories of profit in the next chapter.

2.3 FUNCTIONS OF AN ENTREPRENEUR

From the above discussion, it will be clear that the entrepreneur gets the profits. The question arises as to why he gets profits. There are at least four important functions of an entrepreneur:

- (i) Discovery of an idea and forecasting;
- (ii) Combining of factors of production;
- (iii) Accepting risk and uncertainty;
- (iv) Ultimate responsibility of control.

The entrepreneur is the person to whom the idea of establishing an industry occurs. Due to his broad vision and foresight, he is in a position to forecast the scope of the business. Only a few persons have such foresight and everyone cannot have it. He has to decide what, where and how to produce.

It is the job of the entrepreneur to organise the business. He has to pool together the resources and effectively organise and coordinate their activities to achieve the objective with the minimum cost and effort.

Since the future of an industry is unknown and the demand for the product is uncertain, the entrepreneur volunteers himself to bear the risk and uncertainty attached with the venture.

A man who willingly accepts risk and uncertainty, performs an invaluable service to the community, as even some of the richest persons in the economy have no such courage.

Last but not the least, the ultimate responsibility of control lies with the entrepreneur. If the company suffers a loss, it will be impossible to pin-point the responsibility for the loss. Every employee will try to pass on the responsibility to some other fellow employee. Even if one of the employees is detected who was responsible for the loss, - though it is almost impossible -, the loss is very difficult to be made good. It is only the entrepreneur who has to bear the loss as the ultimate responsibility of control lies with him.

The source is clearly related to the reason that to the entrepreneur's competition. A large part of the profit can be attributed to important decisions and innovation which usually place a firm in an advantageous position relative to the others. Profit may come due to uncertainty which may represent the number of firms in an industry by discouraging the entry of new firms along the firm in the industry more than usual rate of profit. Profits, as such, continue due to the lack of freedom of entry. The latter point of view stresses the

CHAPTER THREETHEORIES OF PROFIT3.1 CAPITALISTIC POINT OF VIEW

The economists belonging to the Capitalist School of thought have put forth many theories which explain the nature of profit. These theories can be classified into two types:

- (i) the type of theory which regards profit as a residual, the excess of price over cost; and
- (ii) the theory which regards profit as the reward for a factor of production, the enterprise, or the entrepreneur, in the same way that wages are regarded as the reward of labour, and interest for capital.

The former is closely related in the recent times to the monopolistic competition. A large part of the profit can be attributed to imperfect competition and innovation which usually places a firm in an advantageous position relative to the others. Profit may arise due to uncertainty which may restrict the number of firms in an industry by discouraging the entry of new firms giving the firms in the industry more than normal rate of profit. Profits, as such, continue due to the lack of freedom of entry. The latter point of view stresses the

relationship between profit and dynamic changes. The stalwarts of this point of view treat enterprise as a factor of production and attribute profits to some function or functions of the entrepreneur. It is, however, difficult to define the entrepreneurial function and locate it in the corporate form of enterprise.¹

The author does not intend to take up all the theories here. However, a brief discussion of some of the important theories covering both the types is given below.²

One of the oldest theories which compares profits with rent is given below:

3.1.1 Rent Theory of Profit

F.A. Walker, who developed this theory, seems to be very much impressed by the Ricardian Theory of Rent, as this theory is developed exactly on the same lines. According to this theory, profit is the result of superior ability or as what Walker calls it "Rent of ability". As in the Ricardian Theory of Rent, there are several grades of land, this theory talks of businessmen of different abilities. Some are highly capable, some are almost incapable, and most of them are moderately capable. The businessman who earns no profit, may be called a Marginal Businessman or a No-profit Entrepreneur, in the same manner as we have marginal or no rent land in the Ricardian Theory of Rent. As rent arises

due to the differential advantage possessed by the land, so profit arises due to the exceptional ability possessed by a businessman. Walker stresses that the amount which the entrepreneur could have earned had he sought a job of a manager in some other concern, should not be included in profit. Just as rent does not enter into the price, so profits, according to the theory, also do not enter into the price of the commodity.

We expect from a theory of profit an explanation of the nature of profit. This theory fails to provide such an explanation. It simply gives a rough estimate or measure of profit. It does not even give the main causes of the size of the profit.

The theory fails miserably to explain the profits of an ordinary shareholder of a Joint Stock Company.

The statement that profits do not enter into price, does not seem to be correct. In the short period of time, it may be right, but in the long term since the supply of entrepreneurs is not fixed like land by nature, the cost of production must contain an element of profits.

Another theory, belonging to the second type, which regards profits as wages is given below.

3.1.2 Wages Theory of Profit

Taussig, Davenport and many other economists regard profits 'simply as a form of wages'. According to this theory, businessmen exercise their business ability and the remuneration paid to them for this is in the form of profit. The profit is the excess of revenue over the expenses and it arises due to the skill and ability in organization and meeting risks and not due to chance. Profits are just like wages as the activities of an entrepreneur are a form of labour.

The theory furnishes an explanation of the nature of profit as well as the justification of profit. There are however, some striking differences in wages and profit. We know that in a company, where the ownership and management are different, the profits and the wages of management are two distinct and separate things. The wage is a fixed amount while the profits are irregular and uncertain. This basic difference has been overlooked in the theory. Imperfect competition tends to increase the amount of wages. If there are only a few companies producing the certain product, the probability is that the price of the commodity will be more and the profits as such, will be higher. On the other hand, if there are only a few concerns employing a large number of labourers, the probability is that the wages will be less due to imperfect competition. The main function of an entrepreneur is to assume risks and face uncertainties. A

wage earner on the other hand, practically speaking, assumes no risks. He may lose the job if the industry for which he has been trained, stops production. Otherwise there are no risks. This important difference compels us to differentiate between wages and profits. Moreover, in the case of profits, chance plays a more important role than in the case of wages. Chance and capital gains dominate profits, while these form either no or a very small part of wages. Even in our practical life, we find that an ordinary shareholder does not exercise any function in the business, yet he shares the profits. His task is mostly risk-bearing.

In view of the above, it becomes necessary to treat wages and profits separately and not to intermingle them.

As has been pointed out earlier, one of the functions of an entrepreneur is risk-bearing. The following theory traces profits to risk-bearing.

3.1.3 Risk-Bearing Theory of Profit

The exponent of this theory is F.B. Hawley. According to this theory, profits arise because of the risk inherent in the enterprise. The risk is inherent in every business and the most important function of an entrepreneur is to bear the risk. No one will like to bear the risk unless he is suitably rewarded for the risk bearing. If a man can earn interest @ 3 percent by depositing the money in a bank, where there is

practically speaking no risk, he will not be prepared to invest it in some risky business if he does not expect to get a return of much more than 3 percent. As such the rate of profit must be higher than the normal rate of return, or in other words, the reward for risk taking must be higher than the average value of risks borne. The number of persons who come forward to bear the risk is always limited as the other persons cannot afford. Due to limited supply, those who embark on risky businesses and survive, can earn a relatively higher return.

No one can deny that profits include rewards for risk taking, but it is incorrect to exclude all other elements besides risk. It is argued that profits arise not because risks are borne, but because shrewd entrepreneurs are able to reduce risks. Strange as it may sound, it can be said, that entrepreneurs get profits not because of the fact that they bear risk, but because they do not risks.

As Knight³ has pointed out, not all kinds of risks give rise to profit. There are certain risks which are known e.g. the average risk of death in a community can be statistically measured. There are some risks which are unknown as their incidence cannot be known before hand. The remuneration for known risks is not profit, but forms a part of the operating costs of a business and profits are something over and above costs.

Furthermore, as Howard and Upton⁴ have pointed out, the investor assumes risks only once when he advances the funds, because at that time, everything is uncertain. Once the business is established, his investment is recovered in a very short period. "The profit, or return, therefore, is a compensation not for bearing risk but for assuming it at one time in the past".

Not too different from the above theory, is another theory which regards profits as reward for uncertainty bearing.

3.1.4 Uncertainty-Bearing Theory of Profit

According to this theory, profit is the reward for uncertainty-bearing. When a new industry is established, its future is uncertain. The entrepreneur bears the uncertainties of production. As bearing uncertainty is not a pleasant thing, the person who is prepared to bear the risk must be rewarded. The reward is profit which accrues to the entrepreneur.

As has been pointed out, Knight maintains that there are known as well as unknown risks. Known risks do not give rise to uncertainty. Only the unknown risks give rise to uncertainty. The persons volunteering themselves to bear the uncertainties must be rewarded. Risks can further be classified into insurable and uninsurable risks. Insurable

risks are usually physical risks, e.g. risk of fire, theft, etc. Uninsurable risks are generally business risks e.g. slackness or shift in demand, etc.

Some economists regard uncertainty bearing as a factor of production just as waiting is regarded as a factor of production. Uncertainty bearing has a supply price depending on:

- (i) The character of the entrepreneurs: Those who are enterprising in nature will not mind embarking on risky projects, while those who are cautious, will not take up even the less risky ones.
- (ii) The total amount of resources possessed by the investors: A man having vast resources is more likely to embark on risky projects as he can afford it.
- (iii) The proportion of resources which will be subject to risk: If a man invests a small proportion of his resources, he may be willing to accept a small reward. But if he invests a large part of the resources, he may not be willing until handsome rewards are paid to him.

Though not always, but often, uncertainty bearing as a factor is not found alone but in combination with capital. Sometimes, the people who are willing to take risks, may not possess capital, while those who have capital, may prefer safe investment. Those persons who supply capital as well as bear risks, have an advantage over others and earn more revenue in the shape of quasi-rent.

It has been maintained by the economists, that uncertainty bearing is not a separate factor of production. Uncertainty bearing can only be regarded as a separate factor of production when we accept the doctrine of real cost according to which all costs are ultimately reduceable into pains and disutilities. But the modern trend is not to accept this doctrine. When we say that workers working under bad working conditions demand higher wages, we do not mean that the bad working conditions are a separate factor of production. It is simply a characteristic of the entrepreneur function and results in increasing the supply price of capital and enterprise.

Uncertainty bearing is one of the functions of the entrepreneur but not the only function. As such, profits cannot be entirely attributed to this one factor to the neglect of the others. There are also other factors like an entrepreneur's organising ability, etc. for which a reward is expected.

Uncertainty bearing is only one of the factors that limit the supply of the entrepreneurs. Other factors like different elements of social stratification and environment also limit the supply of the entrepreneurs.

A somewhat different approach to profits has been made in the theory given below. This theory maintains that profit is the outcome of dynamic changes.

3.1.5 The Dynamic Theory of Profit

According to the American economist, J.B. Clark, profits arise solely due to dynamic changes. Profits disappear in the static state. We know that profit is the difference between the selling price and the cost. If there is perfect competition and no new changes occur in the economic organisation, each factor will get what it produces, and the selling price would be equal to cost. There would be no profit over the wages of superintendence. As such the main function of the entrepreneur is to effect changes in the economic organisation. When Clark talks of the static state, he assumes that:

- (i) there is no increase in population;
- (ii) there is no increase in the supply of the capital;
- (iii) there is no change in the method of production;
- (iv) there is no change in the form of business organisation; and

- (v) there is no change in the wants of the customers.

An entrepreneur by his superior ability, disturbs this equilibrium. By invention or by better organisation, he reduces expenses and as such he gets profits. But competition sets in, other entrepreneurs adopt the new method, and due to the competition, rates of wages and interest increase, bringing up the costs to the level of the selling price. At this stage profits disappear. Profits, as such, are temporary and casual. The entrepreneur by creating changes, earns profits but is soon forced to yield this profit to the society in the form of (i) higher wages, (ii) higher interest rates, and (iii) lower prices.

In a static state, profits would tend to be zero as "the ultimate goal of the whole movement is a no profit state". But in actual life, (i) changes are constantly taking place, and (ii) competition is not perfect. As such, profits have become a regular feature rather than a temporary one.

Knight⁵ maintains that not all kinds of changes yield profit. Changes which can be measured before hand can be discounted in advance. The financial implications of these changes can be determined and included in the costs. Only the unforeseen and unpredictable changes can yield profit.

Taussig⁶ does not like the artificial distinction between the profit and the earnings of management. He says:

"Even the routine conduct of the established industries calls for judgement and administrative capacity, for the exercise of the same faculties that are more conspicuously and more profitably exercised under conditions of rapid progress".

In a static state, reward for risk taking would disappear, if the risks do not exist, but the entrepreneurs would continue to secure wages of management. The major parts of the risks would not exist but certain risks to which Marshall gives the name of personal risk, e.g. the risk of loss by fire, risk of defalcation of employees, etc. would remain and reward must be given for these risks.

Lastly, the theory which is very common to the distribution part of economics, is the marginal productivity theory.

3.1.6 The Marginal Productivity Theory of Profit

Just as the reward of any other factor of production depends on the marginal productivity of the particular factor, so according to this theory profits would tend to equal the marginal net product of the factor organisation. The marginal net product may be defined as "the amount which the community

is able to produce with his help over and above it would produce without his help". There is some difference in the way marginal social worth of the workers and the entrepreneur is determined. As has been pointed out by Chapman, the marginal net product of the workmen is determined directly, whereas "the forces bearing upon the employers' remuneration operate indirectly and more tardily".

But the difficulty with the above theory is that the unit of the factor organisation is so large that the withdrawal of one entrepreneur might mean disorganisation of the whole. As such it is difficult to measure the marginal productivity of the entrepreneur. On the other hand, the unit of the factor labour is comparatively easy to be determined.

The productivity of other factors can be measured directly but the productivity of the entrepreneur is measured indirectly in a more haphazard fashion by the immediate of their own competition. Hence the measurement is not exact, if not impossible.

3.2 SOCIALISTIC POINT OF VIEW

It was maintained by some economists before Karl Marx that the capitalists through cheating or "force majeure" underpaid their workers i.e. paid them less than their value. Moreover, the capitalists sold their products for more than their cost i.e. above their value. Karl Marx was not

satisfied with this as the objection was refuted by the economist belonging to the capitalistic school of thought on the grounds that it was due to imperfect competition, the abolition of which they were advocating. Marx, as such, tried to explain how a class in the society drew an income without contributing any productive activity, and how it was not inconsistent with the competition and the rule of economic law. In the words of Karl Marx,⁷

"To explain the general nature of profits, you must start from the theorem that, on an average, commodities are sold at their real values, and that profits are derived from selling them at their value.....If you cannot explain profit upon this supposition, you cannot explain it at all."

Karl Marx further maintains that interest is a part of profit. This he explains as follows: suppose a man has \$ 25 with him. The rate of profit being 20 percent, he can earn \$ 5 by investing this money. If instead of investing it, he lends it to someone at an interest rate of 5 percent, who employs it as capital. The borrower will earn \$ 5 at the end of the year and will transfer \$ 1.25 out of \$ 5 to the lender. "That part of the profit paid by him is called interest, which is thus but a special name for designating a part of the profit."⁸

According to the Marxian theory, value is determined not only by labour, but belongs wholly to labour. But a part

of the value was usurped by the capitalists in the shape of profits which is not justified.

In view of the above, the socialist school has vehemently criticised profit and described it as "legal robbery".

Abolition of profit is possible only when the private property is abolished. But whether it is desirable or not and what will be its consequences, cannot be dealt with here in this thesis.

Even the most ardent supporters of capitalism have to admit that there are some elements in profits which cannot be justified:

(i) the employers, since they are in a better bargaining position, may under-pay the employee and force them to work more and, in this way, may increase the profit margin.

(ii) privileges yielding valuable benefits may be obtained dishonestly.

(iii) the industrialists may bribe the government to levy tariffs.

(iv) gambling and manipulation at the stock exchange may enable persons to become rich.

(v) higher prices may be charged from the consumers on account of the monopolistic position of the manufacturer etc. etc.

In a capitalistic economy, profit is a "must", as it is the reward of the entrepreneur, who performs some very important and essential services. Without the entrepreneur, it would not have been possible for the economy to make headway. In other words, entrepreneurs are responsible, to a very great extent, for the present progress of the economy.

The very foundation of the capitalistic economy is on the profit motive. If this motive is not present, there would be no production at all. It is the profit motive that stimulates the desire to bear uncertainties of production. In fact the market mechanism works with the help of the profit motive.

CHAPTER FOURACCOUNTING CONCEPT AND MEASUREMENT OF PROFIT

Since the early 1930's the determination of periodic net income has been the acknowledged primary function of the accountant. Income determination reached this position of primacy largely because measurements of income were used for an expanding number of purposes. Although some question how well they have served, such measurements have been used for a number of purposes, among them: (1) to appraise the effectiveness of management in using resources; (2) as a basis for predicting future incomes, especially by present and prospective stockholders; (3) management's evaluation of past decisions in order to improve decision-making; (4) as a basis for taxation; (5) as a guide to dividend policy; (6) as a base for price and rate regulation; (7) in determining credit worthiness; (8) in collective bargaining between labour and management; and (9) as a basis in formulating broad social policies.

This chapter describes in general terms present practices used by accountants to measure profit. From an accounting standpoint, profit is generally conceived to be a residuum which emerges out of a matching of expired costs against revenues earned. It is a money concept, measured periodically for a specific business. In order to measure this residual objectively, accountants have introduced

numerous conventions and constructed various procedures. Although further improvement is needed, modern income accounting serves remarkably well the purpose for which it has always been intended.

In this chapter, we shall first present the accountant's concept of profit. We shall then concern ourselves with accrual accounting, trying to demonstrate how, in practice, accounting profit is determined. A major portion of this chapter, therefore is concerned with a study of the characteristics of expenses and revenues.

4.1 THE ACCOUNTANTS' CONCEPT OF PROFIT

There is general agreement among the accountants that profit is the excess of revenues over expenses and that it is to be measured at least originally on transaction-based data.

The 1957 Revision of "Accounting and Reporting Standards for Corporate Financial Statements" defines income in this manner:

"The realized net income of an enterprise measures its effectiveness as an operating unit and is the change in its net assets arising out of (a) the excess or deficiency of revenue compared with related expired cost, and (b) other gains or losses to the enterprise from sales, exchanges, or other conversion of assets. Interest charges, income taxes, and true profit-sharing distributions are not determinants of enterprise net income." (1)

Gordon defines Accounting Income as follows:

"Income is the amount by which realized sales revenue for a period exceeds the historical cost (measured in number of dollars spent, regardless of their purchasing power) of the assets used up to obtain the revenue." (2)

The key words in the above definitions are realized, net income, net assets, revenue, and expired cost.

Realization of Revenue: A business expects to receive an inflow of assets - mostly money and claims to money - in exchange for its goods and services. When this inflow is assured and its amount is definitely measurable, revenue (the inflow of new assets in exchange for the goods and services of the business) is said to be realized.

Expired Costs: Income is the net effect on owners' equity of flows of assets into and out of the business as a result of business activity. The inflow of assets resulting from business activity is called revenue. The outflow of assets - or more literally, the using up of asset service benefits - in connection with earning the revenue is called expense. Productive assets are measured initially at their acquisition cost to the business; therefore, the expiration of their service potentials is measured as that part of the assets' acquisition cost which is proportionate to the expired service benefits.

Other deductions from revenue in computing income and losses - either the expiration of costs without benefit to the business or the disposal of assets for less than their unexpired cost.

Net Income and Net Loss: Income can be either positive or negative. If business operations are successful, revenues and gains will exceed expenses and losses, and there will be a positive net income - and a corresponding increase in the net assets and owners' equity of the business. If expenses and losses exceed revenues and gains, there is a negative income and a corresponding decrease in net assets and owners' equity. Negative income is called net loss, which should not be confused with some of the negative components of income, such as losses from uncollectible accounts, from the sale of property at less than its cost, and from natural disasters such as fires or floods.

Net Assets refers to the amount by which total assets exceed total liabilities. Thus, $\text{Assets} - \text{Liabilities} = \text{Net Assets}$. If the net assets of a business increase as a result of operations, the business has earned a net income. If they decrease, it has incurred a net loss. Income does not include the effect of any transactions with the owners of the business, such as the payment of dividends or the investment or withdrawal of assets. Profit is a widely used synonym for accounting income.

4.1.1 The Transactions Approach

Under the transactions approach, revenues and expenses are recorded as changes in assets and equities become evident as a result of an entity's transactions. The term "transactions" is used in the broad sense to include both internal and external transactions. External transactions arise from dealing with outsiders and the transfer of assets or liabilities to or from the firm. Internal transactions arise from the use or conversion of assets within the firm.

Advantages: Considerable useful information, not normally found in the balance-sheet approach, is or can be accumulated under the transactions approach to income measurement. This includes:³

- (i) total gross revenues as well as revenues by product lines or divisions;
- (ii) income classified as to sources (operating versus non-operating);
- (iii) income by product lines or divisions; and
- (iv) a recorded guide to the inventorying of assets and liabilities at the end of the period.

And since the rights and obligations of an entity virtually require the recording of transactions with outsiders, the information accorded lends itself to an economical determination of income.

The general procedure is to record revenues and expenses as they arise from external transactions. The problem of timing and valuation are present in the recording of each transaction, but the main problem is focussed upon the proper matching of expenses with the related revenue reported during the specific period. These problems are discussed later in the chapter.

Capital Maintenance and the Transactions Approach: Standing alone, the transactions approach yields an incomplete determination of income. Certain changes, such as the expiration of the service potential of plant assets, are not reflected in transactions, at least not until the asset is disposed of. Consequently, the measurement of income in practice involves a combination of the transactions and balance sheet approaches. The following table synthesizes the notions that income is the excess of revenues over related expenses and that income cannot exist until capital is maintained:⁴

	Assets	-	Liabilities	=	Owners' Equity (Net assets)	Income Statement
Balance, January 1	£ 100		£ 40		£ 60	
Revenues	+ 20				+ 20	£ 20
Related Expenses	- 10		+ 5		- 13	- 13
Balance, December 31	£ 110		£ 45		£ 67	£ 7

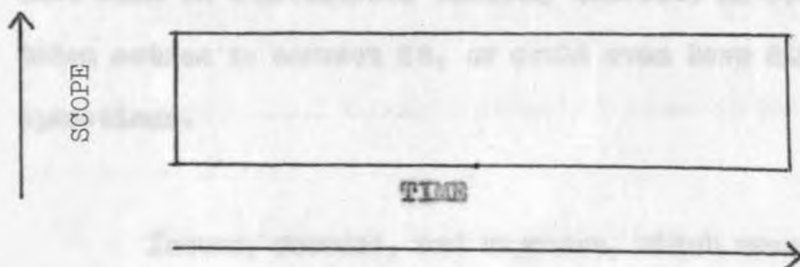
Assuming the above amounts to represent thousands of pounds, the net income is £ 7,000 and can be determined by subtracting £ 13,000 of related expenses from the £ 20,000 of revenues, or by deducting the beginning owners' equity of £ 60,000 from the ending equity of £ 67,000. The two approaches will always yield the same amount of net income if the same basis of valuation is employed and if capital changes and dividends are taken into account.

If the terms "revenues" and "related expenses" are defined broadly enough to include the recognition of changes not reflected in transactions, a number of different bases of valuation could be employed in the above model and in actual practice. But the typical approach is to include only transaction-based data (usually described as historical costs).

4.2 PARTITIONING INPUT/OUTPUT ELEMENTS: SEGMENTAL INCOME⁵

If the operation of a business consisted of a single, brief undertaking, such as the purchase of a block of corporate stock in the hope of making a quick speculative gain, the problem of measuring business income would be rather simple. The venture would be in progress for such a short time that there would not be much need for financial statements during its life. It would be satisfactory to measure its income at the completion of the venture. Income would be the difference between the net assets available for distribution to the owners at the end of the venture and the amount originally invested. In most cases, however, it is not satisfactory to wait until the termination of a business to compute its income. Most modern businesses are not of this temporary, or venture, type, but are formed with the purpose of operating indefinitely. The life-spans of most businesses are unknown. As already mentioned, businesses are generally formed with the assumption that they will continue indefinitely. Likewise, the kinds of activities that firms will engage in are also relatively unlimited. A firm may start out selling meat and end up a departmental store. Today there are companies in such diverse areas as soap and paper, motion pictures and tyres, bus transportation and computer leasing, autos and locomotives, nuclear generators and toasters, and the like. Financial accounting includes evaluation of income for parts, or segments, of both the time and scope aspects of business

activity. That is, accountants may determine profit for year 1 or year 2 of business activity as well as for product 1 or product 2 of business activity. In order to clarify what is being segmented, we let the following diagram represent the total activities of an entity. The vertical axis represents the scope or varieties of activities of the entity and the horizontal axis represents the life-span or duration of the activities.



Income information for the typical business must be provided frequently during its life. The stockholder and the banker need quarterly and annual reports of how the business is doing. The income tax collector requires an annual report of income as a basis for collecting tax. The business manager needs monthly, or even more frequent income information to guide him in the day-to-day operation of the enterprise.

Example 1: At the end of a three-year business undertaking, the manager received the following statement:

Net assets available for distribution (= owners' equity) at the end of the venture	£ 24,000
Net assets invested by the owners	£ 28,000
<u>Net Loss</u>	<u>(£ 4,000)</u>

The manager would be justified in objecting to this belated information on the ground that if he had known earlier that such an unprofitable tendency existed, he could have taken action to correct it, or could even have discontinued operations.

Income, revenue, and expenses, which measure the changes in owners' equity resulting from business activity, have meaning only if the period of time over which the change occurs is known. In order to measure their amounts, it is necessary to decide how long the time period is to be and how to select the events to be considered during that period.

Income is a total change which occurs over a period of time. If too long a period is used, total income does not reveal important changes in income's rate and direction, (net income or net loss).

Example 2: The first information that the owner-manager of a business received about its income was

at the end of a year, when he was told that the net income was £ 24,000. He would have been able to manage the business much more intelligently if he had known monthly income results such as the following:

Month	Income for Month	Annual Rate of Income
January	£ 10,000 net income	£ 120,000 net income
February	£ 2,000 net income	£ 24,000 net income
March	£ (1,000) net loss	£ (12,000) net loss

The annual rate for each month shows what the results for the year would have been if the rate at which income was earned during the month continued for an entire year. If January's results were about normal for a month, receipt of the monthly income reports showing a sharp decline in February would have led the manager to investigate its cause, and perhaps the business would thereafter have earned income more nearly in line with the £ 120,000 indicated by January's operations.

Just as each year's income is the result of varying rates of earnings for each of 12 months, so is each month's income composed of weekly, daily and hourly rates. Frequent measurements, upto a practical limit, give better information about the rate at which income is being earned than do

infrequent ones, and they give it in time for appropriate action.

Practically, all businesses determine income at least once a year. The calendar year, January 1 through December 31, is the most popular basic accounting period.

4.2.1 Cash Basis Versus Accrual Basis Accounting

The concept of accrual accounting has been developed to measure business financial progress over time. Accrual accounting identifies business income and its components with specific period of time. The accrual basis of accounting is practically universal among medium and large business firms, but individuals in their personal accounting and many small businessmen use the cash basis. Cash basis income is defined as cash operating receipts minus cash operating disbursements. In other words, sales revenue is recognised when cash is received, not when services are performed or goods are delivered; with few exceptions, expenses are measured by the cash disbursements made during the period.

It is reasonably simple to measure actual cash receipts and actual cash disbursements during relatively short, specified periods of time during the life of a business enterprise. This can be done with a high degree of objectivity. For some purposes the excess of cash receipts

over cash disbursements, adjusted for any cash investments by owners and any cash distributions to owners, may be used as a measure of income. For certain type of business firms cash-basis accounting may provide reasonably useful information - for example, for firms providing services on a strictly cash basis without using depreciable assets which last for more than one period.

Even if services are provided on credit, the collectibility of accounts may be so uncertain as to render the objective measurement of receivables unfeasible. The practices of law and medicine - where the responsibility for supplying services is presumed to be related to need rather than ability to pay - are possible examples. Perhaps the only feasible measurement of the annual income of a small-town lawyer using rented facilities is the excess of cash receipts over cash disbursements each year.

Measurements of the incomes of the vast majority of business enterprises, however, present practical situations which fall somewhere between (1) a feasible measurement of economic income (based on future cash flows) and (2) a useful approximation of income which involves nothing more than the simple measurement of cash receipts and cash disbursements. In "the practical world of business" various combinations of methods and bases for valuation and recognition must be utilized in the measurement of business income.

The goal is to provide the most useful information that is feasible to provide with reasonable objectivity. Information which could be provided only at a cost that is clearly disproportionate to any additional benefits, relative to less costly alternatives, is unfeasible. Accounting periods must be short if the information is to be sufficiently current to be useful - they are rarely longer than one year. When the accounting periods are shorter than the life of the unit being accounted for, pure cash-basis accounting rarely satisfies the goal of usefulness. Most businesses utilize some assets whose useful lives extend beyond one accounting period. Even if their goods and services are sold strictly for cash, a measurement of income based on actual cash flows during a period of time - say, a year - is apt to be misleading because of the erratic incidence of major cash disbursements for long-lived assets and for payment of debt. Similarly, where goods are involved, any measurement of income which ignores varying levels of inventories from period to period is apt to be misleading.

Income Measurement on an Accrual Basis: Whereas the measurement of income on a pure cash basis relies solely on changes in the amount of cash, the measurement of income on an accrual basis involves the recognition of changes in the values assigned to all assets and all liabilities - receivables and payables, inventories, property, plant and equipment, and the like. We should see immediately that any accrual accounting

sacrifices some degree of the extreme objectivity of measurement possible under pure cash-basis accounting. Cash can be counted accurately, but the valuation of other items is likely to involve some judgement and an estimate of the future. We should also recognise, however, that the making of national economic decisions is apt to be facilitated by the more useful information provided by accrual accounting.

Much of the business is conducted on a credit basis. Manufacturers acquire materials from suppliers on account and sell their product to customers on account. Wages are generally paid after they have been earned; taxes and interest are rarely, if ever, paid continuously or in advance. Cash receipts and cash disbursements, therefore, may not occur in the same accounting period as the related sale and the related purchase; the balance of receivables and payables may vary significantly from the end of one period to the end of another. Accordingly, to determine meaningfully financial position and the results of operations for a particular period of time, receivables and payables must be taken into consideration.

A retail grocer might be able to measure quite accurately the cash disbursements made this year for the groceries placed on his shelves. But to decide whether during the year he has made sufficient profit to withdraw

cash without contracting the operations of the business - and thereby probably reducing future profitability - requires information about the amount of inventory on hand at the beginning and on hand at the end of the period. That is, his cash disbursements may have been low because he has unwittingly allowed his inventory to decline. Under such circumstances, the measurement of excess of cash receipts over cash disbursements is useless and misleading as an approximation of income.

For a construction firm that builds to customer specification and carries no inventories, the cash disbursements for materials and labour might represent a reasonably good measurement of those costs. But, if in the measurement of income, there is no deduction for the depreciation of the long-lived equipment utilized, the income figure is surely overstated. Such "income" would be wholly uninformative with respect to growth and dividend potential; expired services must be replaced, or the enterprise will cease to be a continuing enterprise.

The Accrual Concept: As already mentioned, the concept of accrual accounting has been developed to measure business financial progress over time. Accrual accounting identifies business income and its components with specific periods of time.

Whatever the time period selected for computing the income of a business, it is artificial. Business activity does not come to a sharp conclusion simply because the last day of the accounting period has ended. Instead, there will be quantities of unsold merchandise on hand; shipments in transit to customers and from suppliers; accounts to be collected; bills to be paid; contracts for services, both with customers and with suppliers, in various stages of completion; productive facilities with various fractions of their useful lives expired - in fact, many business activities at many stages of progress.

In the case of this complexity of real business events, accountants have developed guides for determining what revenue the business has earned during the accounting and what costs have expired, as well as what other gains and losses have occurred. Accrual accounting identifies revenue and expired cost, gains and losses, with specific accounting periods. It consists essentially of the following steps:⁶

- (i) selecting a type of event whose occurrence is an appropriate signal for recognising that the business has realized revenue;
- (ii) determining the money amounts of such events which have occurred during the accounting period;

- (iii) measuring the costs which have expired by identifying the benefits received directly with the revenue events;
- (iv) measuring other costs which have expired because they are related to the accounting period, or have no benefit to future periods; and
- (v) determining what other gains and losses, unrelated to the sales of goods and services by the business, have occurred during the period.

The heart of the accrual accounting process consists of matching revenue with the related expired costs (expenses). In this matching, revenue is ordinarily the controlling factor. After revenue has been identified with the accounting period, the costs which are casually related to the revenue are charged against the revenue of the same period. Costs which cannot be identified with particular segments of revenue are accrued (recognised in the accounts as deductions from revenue) in the accounting period when the business is assumed to receive the related service.

4.2.2 The Conventional System of Accounting

The conventional accounting procedure of associating expired costs with earned revenue is often described as the "Historical Cost - Realized Revenue" basis of determining income and value.

This basis of accounting has evolved over a long period of time. Even before the days of Pacioli, and for a long period thereafter, the system of "venture accounting" was used by merchants, whose main interest was in determining the surplus remaining at the conclusion of each of their "ventures", (ship's voyages, etc.). However, the rise of the joint stock company, in Britain, the United States and other countries, resulted in the creation of a growing number of separate legal entities, within whose framework capitalists conducted a series of ventures continuing over an indefinite period of time. This led to a growing emphasis on the importance of the balance sheet and to a conservative system of asset valuation which was designed to protect the creditors of family-owned enterprises. In the twentieth century the rise of technology has created an enormous demand for capital beyond the resources of virtually any large family company. The consequence has been the divorce of ownership from management, and the creation of sophisticated securities markets to tap the savings of the domestic (and in many

cases the international) community of investors. The result of this is that the Balance Sheet has remained an important statement, but the dominant statement today is the statement of profit and loss.

The accountant measures income by the process of "matching" costs against revenues. The costs which are matched in the income statement are the historical values at which the transactions were originally recorded in the books of account. In the case of items where the benefit is received and utilized by the enterprise at virtually the same time that the cost is incurred (e.g. wages, and many other current expenses), "Historical cost" is very close to "Current cost". But wherever there is a time lag between acquisition and utilization, "Historical cost" may well differ from "Current cost" at the point of utilization. In the case of these latter items the unexpired costs are stored in asset accounts and will appear as such on a balance sheet. All of the various rules which have been developed by the accountant for the valuation of inventories, depreciation of fixed assets, amortisation of prepaid expenses and deferred charges, etc. are measurement rules for reallocating unexpired asset costs into expense accounts as the assets' services are utilized and expiration occurs. Thus the matching process, so far as it relates to cost side of the equation, involves the direct charging of current items (such as wages) to expense account, and the allocation of expired

asset costs to expense account.

On the revenue side of the equation, the accountant has also developed a concept, the Realization Principle, to assist him in the matching process. Only realized revenues are brought into the income statement to be matched against costs. "Realization requires the existence of a market transaction in which the entity has supplied the goods and services contracted for, and the vendee has supplied the required consideration in the form of measurable liquid assets. It is generally accepted by most accountants that cash, marketable securities, and accounts receivable constitute liquid assets for purposes of the realization concept.

The realization concept has two obvious and important implications:

(1) Accounting does not record current values.

The requirement that there must be a market transaction precludes recognition of upward value changes even when they are readily measurable. Thus, holdings of marketable securities are not valued on a balance sheet at their quoted stock exchange value on the date of the balance sheet, even when the holding represents only a relatively small investment in the shares of a very large public company, because - in the absence of a market transaction, i.e. a sale by the entity -

realization has not taken place.

In other words, if the realization rule is applied to assets in a strict way, it follows that they cannot increase or decrease in value on the company's books, except as they are sold or imputed to be consumed in sales (though such imputations may be made in terms of values). From this it follows that, in a dynamic, restless economy, the amount shown by the accountant for an asset can represent that asset's current value only by sheer coincidence.⁷

This, of course, is neither the lay man's concept of what the accountant's figures mean nor the impression that is often given by the accountant's reports. Sanders' comment of almost forty years ago is still quite true today:

".....the use of the word "value" has persisted.....(because of) the common use and convenience of the word for all occasions when things need to be stated in amounts of money. From this it is a too easy transition to the position of giving, or at least pretending to give, the layman what he expects to find in the balance sheet, namely, the present value of the assets there listed. Indeed, it is so much easier to give this delusive satisfaction to those untaught in accounting than it is to explain to them what the balance-sheet does mean that it must be confessed that the matter has been treated largely by evasion and default." (8)

(11) Accounting records assets at historical costs.

The second implication of the realization principle is that all assets are valued at historical costs - until after realization has taken place. Thus accounts receivable, being post-realization assets, are valued at net realizable value, whereas inventories, fixed assets, etc. are valued at historical cost.

There are three exceptions to this general rule.

The matching rules relating to fixed assets result in fixed assets being valued at historical cost less accumulated depreciation; and conservatism dictates that unrealized losses on inventories are recognised when market falls below cost. Such unrealized losses are not normally recognised in the case of fixed assets unless there is a "permanent loss of value".

The third exception arises when production rather than sales constitutes the main constraint operating on the enterprise. In such cases the realization principle is often relaxed, and thus it is customary for gold mines to value their inventories at net realizable value rather than at historical cost.

The Money Capital Maintenance Concept: Earlier, it is noted that because of the double-entry accounting system, there is a close relationship between the income

statement and the balance sheet. Valuation rules in the balance sheet have their implications for the income statement, and the matching process in the income account determines the values and equities shown in the balance sheet. As such we can see that the historical cost/realized revenue system implies a concept of income which ensures the maintenance intact of the original money capital invested in the enterprise. It also assumes that there will be no change in general purchasing power, or in the specific prices of individual assets between acquisition and replacement. Anything in excess of the number of contributed money units is looked upon as "profit".

4.3 THE MEASUREMENT OF ACCOUNTING PROFIT

Income determination is a central activity in modern accounting practice. This fact, together with the transactions approach to income determination, tends to explain why attention to the nature, measurement, and time of recognition of revenues and expenses prevades most of what is done in accounting today. Before we discuss the current practice (and in certain cases the theory) of revenue and expense recognition, let us first have a look at the accounting principles underlying income measurement. Alternative terms for accounting principles include standards, postulates, assumptions, basic concepts, axioms and conventions. These principles represent concepts developed by the accounting profession in an effort to meet the needs of the users of financial statements.

4.3.1 Accounting Principles Underlying Income Measurement

In any field of thought there are certain known and unknowns, and the unknowns are filled by assumptions in order to weave together the assumptions and the knowns into a complete theoretical structure.⁹ The assumptions are the "givens", that are taken for granted in order that conclusions can be reached despite unavoidable gaps in our knowledge. Thus assumptions are the "building blocks" in the construction of theory.

The conceptual framework of accounting also consists of a series of broad interrelated principles or assumptions supported by an elaborate set of procedural guidelines or rules. Accounting principles are not immutable. Presumably, they will continue to change with shifting economic and social relationships.

The following principles shall be discussed here:

(a) Specific-Separate-Entity: An entity is a specific unit. Since economic activity is carried on by various legal and economic activities, accounting results are summarized in terms of these entities. Accountants deal primarily with three general kinds of business entities: the individual proprietorship, the partnership, and the corporation. Regardless of the form of organisation, however, the business is considered an entity and its affairs are distinguished from

those of its owner. We see the effect of this principle when accounting income is measured as it accrues to the entity in the form of realized increases in net assets, not when it is distributed to owners. Similarly, an obligation of the entity to owners is treated as a liability on the balance sheet, despite the fact that in a sense the owners owe a portion of the debt to themselves.

By assuming that he is accounting for a specific entity, the accountant defines the area of interest. The assumption allows the accountant to narrow his focus of interest. The accountant has to know what he is accounting for before he can prepare meaningful financial reports. Thus the accountant records, classifies, summarizes, verifies, reports, and interprets the financial data of a specific entity.

This assumption is made not only because it defines the area of interest needed to provide relevant economic information, but also as the result of the difficulty, in some cases, of distinguishing between personal and business transactions.

The entity concept is both useful and acceptable. Large corporations are characterized by a wide dispersion of readily transferable stock certificates, are economically divorced from their capital contributors, and possess unlimited

lives. The concept of a separate business entity provides support for the cost principle, matching costs against revenues, and the period convention and to that extent is useful.

(b) Going-Concern (continuity) Principle: Unless there is specific evidence to the contrary, the accountant assumes, in preparing the financial statements of a particular business firm, that the firm will continue to be in existence in the foreseeable future. This does not imply a permanent continuance of the firm, but rather that the firm will continue in business long enough to complete current plans and fulfill existing commitments.

The primary reason for this assumption is that it leads to the presentation of financial information that may aid users of financial statements in making financial decisions with regard to future profitability and financial position of a particular business firm (that is, aid in making financial predictions). In contrast to the going-concern viewpoint, in the normal situation a liquidation viewpoint would not provide useful information for making financial decisions. Thus the going-concern assumption removes a liquidation viewpoint from the financial statements, so that assets are not reported at forced-liquidation amounts (in which there would be losses) and liabilities are not stated as being immediately payable (where such payments would be in excess of present value). With the adoption of

the principle of the going-concern, fixed assets, inventories and intangibles are no longer regarded as marketable wealth but rather as deferred costs to be matched against future revenue. This constitutes an important shift in emphasis from the balance sheet to the income statement.

(c) Fiscal-Period (periodicity) Principle: The individualistic nature of the business entity and its indeterminate life span have created a need for interim progress reports to provide economic information useful for financial decision-making. Although accountants frequently prepare quarterly or even monthly financial statements, the most commonly accepted accounting period is either the calendar or natural business year. It should be recognized, however, that income can be determined precisely only at the termination of the entity's life.

The flow of entity transactions does not conform exactly to prescribed time intervals. The period convention, has thus given birth to the accrual basis of accounting. This entails the assignment of revenue to the period in which it was realized (rather than received) and the application of costs to the period benefiting from the services (rather than accrued). For example, sales of merchandise will ordinarily be considered as revenue during the year in which the shipment took place, regardless of when payment is received. Rent paid in advance will be prorated between successive years according to the specific period covered

by the prepayment. There is a large variety of such transactions which require special accounting attention.

(d) Consistency: Emphasis on the earnings statement has accentuated the need for comparability of results between accounting periods. Consistency provides assurance that such comparability will be achieved by requiring uniform and compatible recording of financial data. Under the doctrine of consistency, financial reports are expected to adequately disclose not only the existence of a material departure from previous procedures, but also the effect of the change.

(e) Conservatism: Many decisions by the accountant in the areas of asset valuation and income determination involve the making of estimates and the exercise of judgement. In other words, many accounting determinations do not have a single "correct answer"; a choice must be made among alternative assumptions under conditions of uncertainty. The concept of conservatism holds that when reasonable support exists for alternative methods and for different measurements, the accountant should select the accounting option with the least favourable effect on net income and financial position in the current period. The modern view of conservatism is that deliberate understatement is not an accounting virtue, but that when matters of opinion or estimates are involved, the accountant should proceed with caution and not be too optimistic. Or, as Moonitz states,

"the proper role of conservatism in accounting is to insure that the uncertainties and risk inherent in any given business situation are given adequate consideration." (10)

In its application to the earnings statement conservatism encourages the recognition of all losses that have occurred or are likely to occur but does not acknowledge gains until actually realized. The procedure of reducing inventory values when market has declined below cost but the failure to countenance "write-ups" under reverse conditions can be attributed to conservatism. The early amortization of intangible assets and the restrictions against recording appreciation of assets have also, at least to some extent, been motivated by conservatism. Failure to recognize revenue until a sale has transpired is still another manifestation of conservatism. In its most abusive forms conservatism has sometimes induced deliberate under-statements of earnings through excessive depreciation allowances, expensing of capital additions, and the creation of unwarranted reserves against income. Conservatism exists and plays an important role in existing accounting practice, but that from a normative-theory point of view, deliberate under-statements should be eliminated because it is a very crude attempt to offset uncertainty that could be better handled by modern statistical methods; it conflicts with consistency, comparability, and the proper matching of expenses with revenue; and it can result

in providing misleading information to users of financial statements.

(f) The Cost Principle: Subject to generally recognised exceptions, accountants assume that cost is normally the proper money measurement of a firm's assets at acquisition and of asset usage and conversion within the firm. Cost in actual accounting practice is generally limited to the cash or cash equivalent sacrificed in exchange to obtain assets through purchase (including cost to put in working condition), manufacture and construction for use. In other words, in accounting practice, cost means acquisition cost, which is the total of the exchange prices, or price aggregates to obtain an asset and render it suitable for its intended use.

Since non-monetary assets (such as inventory, land, plant and equipment, long term investments, and deferred charges) are acquired during different time periods, financial records maintained and financial statements prepared subsequent to asset acquisitions reflect past exchange prices, or historical costs. Thus the historical cost assumption is an assumption that accountants should normally use past-purchase exchange prices in the valuation of a firm's assets.

The historical-cost assumption also normally applies to the valuation of liabilities. In accounting practice, liabilities are generally recorded and reported based on the valuation of the assets received, expenses incurred or losses incurred (the debit side of the transaction). Since the valuation of the debit side is based on the historical-cost assumption, accountants generally record and report liabilities based on historical cost. The arguments given by the accountants for justifying the historical-cost assumption will be dealt with later in the chapter.

(g) Revenue-Recognition (Realization) Principle: The continuous nature of the economic activity of a business firm means that the creation of goods and services by a firm is also a continuous-flow process. In other words, the product of a firm (its goods and services) is the joint result of the continuous process of planning, investing, producing, storing, providing goods and services to customers, collecting cash, and providing warranty services. The continuous and joint nature of the process of product creation by a firm means that it is impossible to identify a firm's product with any one stage of the product-creation process. And since revenue is the monetary expression of a firm's product (goods and services), it is also impossible to identify revenue generation with any one stage of the product-creation process. Thus given the continuous and joint nature of the revenue-generation process, how does the accountant determine

when revenue should be recognized for recording and reporting purposes?

Although there are certain exceptions, the accountant normally assumes that out of the whole revenue-generation process of a firm, he can select one point in time to recognize revenue for recording and reporting purposes, and that such point recognition results in providing useful information for evaluating management's efforts directed toward the generation of revenue. Under normal circumstances, for retail, wholesale, and manufacturing business, the accountant uses the point (date) of sale, when goods are delivered and title passes to the buyer, as the basis for revenue recognition. For service-type businesses, the point of sale is when services are performed. The reasoning underlying this widespread practice of recognizing revenue at the point of sale will be considered later in the chapter.

Let us now consider in somewhat more detail the processes by which historic cost accounting measures the constituent elements of the income statement, i.e., revenues and expenses.

4.3.2 Revenues

The primary areas of concern in the accounting for revenues - its nature, measurement, and time of recognition - are discussed below.

The Nature of Revenue: Revenue, like income, is a flow concept and could be defined in non-monetary terms as the productive accomplishment or net product - goods and services - of an entity.¹¹ But since accounting deals in money measurements, revenue is defined as the monetary expression of the goods created or the services rendered.¹² There is no requirement for the goods to have been delivered (as stated in the American Accounting Association's 1957 statement).¹³ Such a requirement would narrow the definition too much since revenues can be recognised before goods are delivered.

The more traditional definition of revenue is that it represents an inflow of assets or net assets into the firm as a result of sale of goods or services. This was the approach of the 1948 American Accounting Association statement.¹⁴ It was also the approach of Sprouse and Moonitz in their definition of revenue as "the increase in the net assets of an enterprise as a result of the production or delivery of goods and the rendering of services".¹⁵ But, as Hendriksen points out, these definitions confuse the measurement of revenue with the revenue process.¹⁶

The Measurement of Revenue: The revenue of an entity is best measured by the immediate exchange value of its goods and services. In current practice, revenue is typically

recorded at the price established in the agreement reached with the customer. But this price measures the exchange value and the revenue involved only when cash is received immediately. And even then an occasional adjustment may be required for expected returns and allowances.

If a claim to cash rather than cash is received, the present value of the claim must be determined either through reference to money markets or by a discounting process. A sale in which a £ 1,000 non-interest-bearing note, due in one year, is received does not, for example, yield £ 1,000 of revenue if the present worth of the note is only £ 940. Revenue from the sale of the product is only £ 940 and the additional £ 60 ultimately collected is a measure of the revenue generated by the resource-loaning activities of the entity.

In actual practice, the discounting of promises to pay future sums is usually ignored because:

- (i) questions arise about what interest rate to employ;
- (ii) since short-term promises are involved, the amounts are likely to be immaterial;

(iii) even if the implicit interest is material, the effect on periodic income is apt to be immaterial since the discounting process involves largely a reclassification of revenues into product sales and interest revenue, which may not be significant information.¹⁷

Revenue is often measured by valuing the asset received, and the value of an asset is its future expected net receipts appropriately discounted for interest and probability factors.¹⁸ Since cash discounts, returns, and other allowances reduce the amount of cash inflow expected, they reduce the value of the asset. And it follows that these items also reduce the amount of revenue involved and should be accounted for as revenue reductions.

The Timing of Revenue Recognition: Accountants have long subscribed to the general guides that revenue should be recorded only after the activities undertaken to create it have been substantially completed and it can be verifiably measured.¹⁹ These may be referred to as the earning and realization of revenue.

The Earning Process: Accountants accept the general notion that virtually all of the activities of an entity are undertaken to produce revenue even though it is conventionally recognised

at the time of the sale of the product created. As a result, revenue is assumed to be earned through time as the various factors of production are brought together to create a product or render a service.²⁰ In other words, all business activity is revenue producing.

But the accountant faces a difficult task in attempting to record the revenue produced by the various activities of an entity. Satisfactory measures of revenue may be available where a product is produced and sold by one division of an entity to another which uses the part to assemble a product to be sold to outsiders. But since market values do not exist for, say, an automobile before and after a door is installed, most attempts to assign revenue to individual activities will involve arbitrary allocations of the revenue produced jointly by these activities. Where revenues are recognised as production progresses, unless evidence exists to the contrary, the assumption is made that all costs incurred produce equal amounts of revenue. Since it is unlikely that an entity is equally efficient in performing all of its activities, the assumption is conceptually unsatisfactory.²¹

In smaller, single-division, or single-plant entities, the accountant typically refuses to recognise revenue until substantially all of the activity required to produce it has been completed. Revenue is often recognised in multidivision or multicorporation entities when products are transferred

between divisions or entities. But the income related to such revenues is eliminated in the preparation of the consolidated financial statements if the product has not been sold to outsiders.

An alternative to the reporting of revenue at the time of accomplishing the major economic activity is the critical event (or crucial event) concept of revenue reporting.²² This concept suggests that the most appropriate moment of time to report revenue is when the most critical decision is made or when the most difficult task is performed. This could be at the point when the contract is signed, the time when the services are performed, when the cash is collected, or at some other time.

Realization: The term revenue realization is used in a technical sense by accountants to establish specific rules for the timing of revenue reporting under circumstances where no single solution is necessarily superior to others in the above context of revenue. The realization concept has, therefore, become a pragmatic test for the timing of revenue. While many attempts have been made to give it theoretical content, there is no agreement about its precise meaning and the extent to which it is to be applied. Sprouse and Moonitz reject the term and the notion itself because (i) it lacks analytical precision, (ii) it conflicts, by emphasizing the

act of sale, with the postulated continuity of business activity, and (iii) its application may assign revenues to the wrong period, that is, to the period of sale rather than the period of earning.²³

The general view of realization is that it represents the reporting of revenue when an exchange or severance has occurred. That is, goods or services must have been transferred to a customer or client, giving rise to either the receipt of cash or a claim to cash or other assets. In this view, realization cannot take place by the holding of assets or as a result of the production process alone. Thus, the term "realization" has come generally to mean the reporting of revenue when it has been validated by sale. The reporting of revenue prior to or subsequent to the point of sale is generally considered an exception to the realization rule.

Realization is broadly defined and not related directly to revenue recognition in the American Accounting Association's 1957 statement. It defined it as follows:

"The essential meaning of realization is that a change in an asset or liability has become sufficiently definite and objective to warrant recognition in the accounts." (24)

All such changes are to be analyzed to their source and, if related to the product of the entity, recognized as revenue.

The 1964 A.A.A. Committee on realization suggested three tests of realization: (i) revenue must be capable of measurement, even though this measurement may of necessity be an estimation; (ii) the measurement must be verifiable on the basis of a market transaction, to which the accounting entity must be a party; and (iii) the crucial event in the revenue process must have occurred.²⁵

Bases of Revenue Recognition:²⁶ In current practice, the two primary criteria for recording in the accounts that revenue has been realized are:

- (i) sufficient objective evidence exists as to the market value of the output. Usually such evidence is provided by an arm's length sales transaction.
- (ii) the earnings process (in essence the creation of marketable goods and services) must be substantially complete. This means that all necessary costs have been incurred or can be reasonably estimated.

The Sales Basis: Revenue is widely recorded at the time of sale. In applying the above criteria to various practical situations, the most widely accepted evidence of realization is the sale of goods. The adoption of the sale basis is the accountant's practical solution to the extremely difficult problem of measuring revenue under conditions of uncertainty as to the future. The revenue is equal to the amount of cash that will be received due to the operations of the current accounting period, but this amount will not be definitely known until such cash is collected. The accountant, under these circumstances, insists on having "objective evidence", that is, evidence external to the firm itself, on which to base his estimate of the amount of cash that will be received. The sale is considered to be the earliest point at which this evidence is available in the usual case. Until the sale is made, any estimate of the value of inventory is based entirely on the opinion of the management of the firm. When the sale is made, however, an outsider, the buyer, has corroborated the estimate of management and a value can now be assigned based on this transaction. This sale also leads to a valid claim against the buyer and gives the seller the full support of the law in enforcing collection. In a highly developed economy where the probability of collection is high this gives additional weight to the sale in the determination of the amount to be collected. Ordinarily there is a transfer of control as well as title at the sales point. This not only serves as additional objective evidence

but necessitates the recognition of a change in the nature of assets. Usually the change is for an amount which differs from the costs assigned to the item being sold. The sale, then, has been adopted because it provides the accountant with his objective evidence as to the amount of revenue that will be collected, subject of course to the bad debts estimate to determine ultimate collectibility.

It should not be assumed, however, that sale and realization are synonymous. Under certain circumstances, accountants are willing to record realized revenue at the three other stages in the productive process discussed below.

Production Basis - Production in Process: Recognising revenue concurrently with the undertaking of the activity which creates it seems to be nearly a theoretic ideal, especially if production is the critical event. This ideal is approached in the accounting for many service revenues, such as interest and rent and those revenues derived from most personal services. The service is usually performed under the terms of a prior agreement. Such performance - the earning process - gives rise to a claim upon the recipient. The revenue is now earned and realized and can even be said to be based upon a market transaction - the original contract. It is properly recorded at this time.

In some businesses the product consists of a small number of major projects which require considerable time to complete. Major construction projects such as dams or large ships are examples. For such projects production is the major element of the earning process; the final sale is assured by a binding contract subject only to satisfactory performance by the producer. In the case of such long-term contracts, the use of the "sales basis" would result in a distortion of the periodic income figures. Therefore, as progress on the project is made, portions of the reconstruction are revalued and a percentage of the ultimate contract price is recorded as realized revenue. In general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable to the completed-contracts method.

Production Basis - Production Completed: Recognising revenue upon completion of production is sanctioned in practice for certain precious metals, such as gold and silver, which can be sold with no substantial marketing costs at a fixed, government-supported price. For other metals and agricultural products, the requirements are similar but expanded: (i) a stable market price, (ii) no substantial marketing costs, (iii) interchangeability of units, and (iv) difficulty in obtaining approximate actual costs.

Where the above conditions exist, strong theoretical justification supports recognising revenue upon completion of production. The revenue has been earned - production is the critical event - and the costs of production are likely to be known. The time of revenue recognition is advanced, thereby narrowing the gap between the point of recognition and the expenditure of effort to produce it. Also, the revenue is measurable with a high degree of accuracy. The delivery and selling expenses to be incurred can be estimated with reasonable accuracy since their incurrence is likely to be routine.

Cash Collection Basis: The two procedures discussed above move the point of realisation forward to an earlier stage in the production process, that is, prior to the point of sale. Another possibility is that the recognition of revenue should be delayed beyond the point of sale until additional evidence corroborates the significance of the sales transaction. An extreme application of this test of realisation is the so-called cash basis of accounting. This calls for recognising revenue only when cash is received, and recognising expenses at the time cash is paid out.

Recognising revenue as cash is collected is generally appropriate only where cash receipt is accompanied by delivery of product or rendering of service - in effect, the sales basis.

Despite critical event theory, the recognition of revenue upon receipt of cash, but prior to delivery of product or rendering of service, is generally rejected in practice. At the same time, delaying the recognition of earned revenue until cash is received is not in accord with the accrual basis of accounting. Consequently, the cash basis of accounting is sanctioned for its expediency, objectivity, and conservatism rather than its theory.

Let us see the support in critical event theory for the instalment basis of revenue recognition. In the case of instalment sales the probability of uncollectibility may be great due to the nature of the collection terms. The sale itself, therefore, does not give an accurate basis on which to estimate the amount of cash that will be collected. It is necessary to adopt a basis which will give a reasonably accurate estimate. The instalment sales method is a modified cash basis; revenue (and thus income) is recognised as cash is collected from customers.

4.3.3 Expenses

The primary areas of concern in the accounting for expenses - its nature, measurement, and the time of recognition are discussed below.

The Nature of Expenses: Expenses are the using of consuming of goods and services in the process of obtaining revenues. It is a flow concept. They are the expirations of factor services related either directly or indirectly to the producing and selling of the product of the enterprise. The values of these factor services expire when they leave the enterprise by final consumption or by the transfer of the product to customers. They acquire new measurements of value by the reporting of revenue prior to sale. When service expirations result in a product still held by the enterprise, but on which revenue has not been reported, the measurement of the goods and services used is assumed to become embodied in the measurement of the product (a transformation of the service value) and there is no final expiration or transfer out of the firm.

Frequently expenses are defined in terms of cost expirations or cost allocations. For example, the 1957 statement of the American Accounting Association defined expense as follows:

"Expense is the expired cost, directly or indirectly related to a given fiscal period, of the flow of goods or services into the market and of related operations." (27)

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by the valuation of the goods or services consumed, but this measurement does not define the expense. A distinction should be made between the measurement of an expense based on cost and the definition of an expense as an activity or process.

Expense Inclusions: As we shall see the recognition of expense generally depends upon expenditure taking place, in order to satisfy the requirement of objective measurement based on good evidence.

However, not all expenditure undertaken by the firm is immediately classified as 'expense'. Expenditures which are thought to be likely to produce benefits lasting more than a year beyond the accounting period in which they are made are classified as capital expenditures. They are subsequently recognised as expense when they are amortized. A different type of example is the payment of dividends. This is generally treated as an appropriation, i.e., a voluntary payment, out of profits, although payments of interest, which are made to service forms of long term capital other than shares, and which fulfil a similar economic function to dividends, are classified as expense. Because interest is more a reward for the use of capital than a cause of revenue, a strong case can be built in entity theory for defining it as a distribution rather than a determinant of income.²⁸ Taxation is commonly described as an appropriation out of profits, presumably because its amount is calculated by reference to a figure of profit.

On the other hand, expenditure need not have been made in a period for expense to be recognised. Thus, provisions may be created against the diminution in value of an asset, or against a known liability of which the amount is uncertain. In the proper delineation of expenses, care should be taken to distinguish between those charges that are expenses and those that are offsets to revenue or valuations of revenue. Sales returns and allowances are normally treated as revenue offsets. On the other hand, sales discounts and bad debt losses have been treated conventionally as expenses.

An exact and complete definition of what is treated as expense in general accounting practice is impossible. It is clearly based on expenditures which have been made on behalf of the firm, but there are several important variations of this general rule.

Expense Measurement: The most common measurements of expenses are (a) historical costs, (b) current measurements such as replacement costs, and (c) opportunity costs or current cash equivalents.

The conventional method of measuring expenses is in terms of the historical cost to the enterprise. The main reason for adhering to the historical costs is that they are assumed to be verifiable, since they represent cash outlays by the firm.

But it is also claimed that they represent the exchange value of the goods and services at the time they were acquired by the enterprise. An essential feature of this argument is that management considered the value of the goods and services to be at least as great as the cost at the time of acquisition or they would not have been acquired. Also, there is no real evidence that the firm would have acquired the goods and services if it had to pay a higher price for them. Thus, the best evidence available indicates that they were worth just what they cost the firm, no more or less. If the goods and services turn out to be worth more than the historical cost, the excess represents a gain to the firm which will be included in aggregate income at the time revenue is reported if the expense is then reported at historical cost. The opposite is the case if the goods and services are subsequently worth less than cost.

But historical cost is not usually supported because it may approximate value. The primary purpose of accounting, as it is claimed, is reporting the stewardship of a corporation's management to stockholders. And a properly drawn report on stewardship shows the stockholders' investment as it is committed or embodied in resources and trace these commitments and embodiments as they flow through an entity to outsiders. Thus, the accountant is urged to be concerned with the investment or costs embodied in resources rather than their value.

The Time of Expense Recognition: By definition, an expense is incurred when goods or services are consumed or used in the process of obtaining revenue. The timing or reporting of expense is brought about by recording this activity in the accounts or including it in financial reports.

When expenses should be reported is, in part, determined by the approach to income being used. In traditional accrual accounting, expense is recognized in the period in which the associated revenue is recognized. This is the matching process - the timing of revenue reporting comes first, followed by the reporting of related expenses in the same period.

The Matching Concept: If revenues were reported gradually over the entire operating process of the firm, the measurement of the product of the firm would be increased as value was added by the firm and other factors of production. In this case, there would be no necessity for a matching concept. But because revenue and expense transactions are reported separately, and because the acquisition and payment for goods and services do not usually coincide with the sales and collection processes related to the same product of the enterprise, matching has come to be considered a necessity or at least desirable. The leads and lags in the acquisition and use of, and payment for, goods and services are assumed to be the reason for accruals or deferrals in order to match the expenses with associated revenue.

Essentially the notion of matching requires that revenues and the expenses incurred to produce them be given concurrent periodic recognition in the accounts. Only if effort (expense) is properly related to accomplishment (revenue) will the difference (income) have any significance as an indicator of efficiency in the use of resources. Thus, the matching principle is a recognition of the cause and effect relationship that exists between expense and revenue.²⁹

The matching of expenses with revenues thus requires the finding of a proper association between the two. All expenses, by definition, are incurred as a necessary part of the revenue operation. This does not mean, however, that revenue will always result; expenses may be incurred without revenue resulting. Several calls by a salesman may be necessary before a sale is made; but all calls should be included in the expenses, as they are necessary in the revenue operations. In fact, even if no sales were made the calls would nevertheless be included in the operating expenses.

The association of expenses with revenue is, therefore, a difficult step. Although necessary to the operation of a business, many expenses simply do not have a discernible relationship to revenues. This difficulty has led accountants to establish specific rules and procedures or to establish basic criteria for the timing of expenses. These basic criteria are established by drawing a distinction between direct expenses

(product costs) and indirect or period expenses.

Product Costs: Certain factors of production - service potentials - are essential to the production of goods. When measured in terms of cost, these service potentials are called product costs. Once a cost is determined to be a product cost, it is related to specific goods and is expensed when the revenue from the sale of the goods is recognised.

It is generally conceded that fairly accurate approximations of the raw material and direct labour components of product cost can be secured, although arbitrary allocations may be necessary in the case of joint products. Indirect manufacturing costs (overhead) can be related to products only via an allocation process. The usual approach is to allocate a part of the cost of every factor of production necessary to the production of goods to each unit of good produced. This approach - absorption costing - is rejected by the supporters of direct costing. Under direct costing, only the variable costs of production are inventoried as product costs, while fixed production costs are expensed as incurred.⁵⁰

The strongest point in favour of direct costing is that the fixed production costs of one period do not represent service potentials and should not be inventoried and carried forward as assets into a subsequent period if all

of the goods which can be sold in this subsequent period can be produced in the period of sale. Under such circumstances, the fixed production costs of the first period can in no way benefit the revenues of the second, or so it is argued. But this may not be true. Production processes are not turned on and off with a flick of the switch. Consequently, inventories must be maintained to prevent loss of sales. Also, lower costs may be obtained from larger production runs, which necessitate carrying inventories.³¹ Thus, a better view is that management seeks to act in a prudent, optimal manner, and carrying inventories usually reflects this.

Direct, Non-Product Costs: Occasionally, costs may be specifically related to certain revenues but not to the goods sold. The best example is a salesman's commission. Such a cost should not be expensed in the period incurred, even if the obligation to pay arises because an order is obtained, if the order is not filled until a subsequent period.

Similarly, a fairly close relationship can be established between costs incurred to promote a new product and the revenues resulting from such product sales. Such costs should not be expensed until revenues from product sales are recognized. Although a question may arise as to the proper period of amortization of such costs, the expensing of such costs in accordance with expected revenue would bring about the desired matching of effort and accomplishment.

In certain instances, costs directly related to specific revenues are incurred subsequent to the period of sale - "after costs" as they are often called. Warranty fulfillment and collection costs are examples. For warranties, revenue is typically recognized at sale and a proper matching secured by accruing the estimated warranty costs to be incurred as expenses of the period of sale. The alternative is to delay recognition of a part of the revenue until the warranty fulfillment costs are incurred and thus assign some revenue to the period in which it is earned by fulfilling the warranty. Collection costs expected to be incurred can also be accrued as expenses of the period of sale, with the alternative - in unusual circumstances - of delaying revenue recognition until cash is collected, where collection costs are expected to be substantial and collection is highly uncertain.

Period Costs: When the cost of seeking revenue cannot be related to any specific revenue it is called a period cost. Period costs are expensed in the period incurred. Typically, they are found only in the selling and administrative functions of a business entity, except where direct costing is employed.

Paton and Littleton hold that under ideal circumstances all costs would be attached to products and expensed when the revenue from their sale is recognized.³² Because all costs

cannot be discernibly related to products, certain expenses are matched against revenues on the basis of time periods. But time period matching is an expedient, not the ideal. Implementation of the Paton and Littleton ideal would require passing all costs through an inventory account and recognising them as an entity's only expense - cost of goods sold.

Yet the period cost concept would seem to be an expedient only because the recognition of revenue is governed by another expedient - realization. When revenue is recognised as it is created (in a value-added sense), all costs related to its production are period costs. The notion of period costs is then the theoretically supportable idea, and the product cost concept becomes nothing more than a functional classification like selling and administrative costs.

Thus, a natural consequence of the accountant's attempt to reduce uncertainty in revenue measurements by relying upon realization is an increase in the uncertainty surrounding the measurement of periodic expense. And this uncertainty tends to be reflected in most of the reasons that justify the period cost concept:³³

(1) Many costs incurred in a period relate so completely to that period's revenues that satisfactory matching is secured by expensing them as incurred - for example, the weekly newspaper advertisement of the local supermarket.

(2) Other costs may bear no relationship to any revenue, yet cannot be avoided if the business is to operate. Such costs are expensed as incurred. For many entities, the cost of the annual audit falls within this classification.

(3) Yet other costs, definitely incurred with the expectation that they will influence future revenues, are expensed as incurred for one or both of two reasons: (i) the benefits expected are so uncertain that they cannot be measured; (ii) even if the benefits are measurable, the amount of cost to be carried over may be estimated only by engaging in arbitrary allocations of joint costs (cost of pure research, contrasted with applied research, is an example).

(4) Finally, certain costs are expensed as incurred because they recur, suggesting that no future benefits from any period's costs are to be expected. And further, even if future benefits are expected, no material distortion would result from immediate expensing, except in the first and last years of an entity's life, if the amounts involved are approximately equal each year. Salaries paid to other than factory employees are examples.

For the above types of cost, a positive correlation with current revenues is assumed simply because "no objectively discernible ability to produce future revenues is associated

with them."⁵⁴ Yet no cost possesses an inherent attribute which requires that it be immediately and always expensed as incurred. Even costs called period costs when the entity is operating must be capitalized in the entity's formative or pre-revenue stage. They cannot be assumed to be the cause of current revenue since there is no current revenue and no attempt has been made to earn any. These costs must, therefore, relate to future revenues.

4.3.4 The Profit Calculation

The expense measurements are matched periodically against the revenue measurements in the income statement, in order to calculate a figure of profit or loss earned by the continuing business at intermediate stages in its existence. Profit is, of course, not a single separate inward flow, but the resultant of numerous inflows and outflows of revenue and expense.

The income statement describes the combination of resources used by the firm, which may be considered as inputs, in order to produce commodities or services for resale, which may be considered as outputs. It is a form of short-term input-output analysis.

A Merchandising Concern: As the name implies, a merchandising concern purchases merchandise from its suppliers and sells them to its customers without making any alteration whatsoever in the merchandise, excepting in some cases when it breaks the bulk or lot. To use economic terminology, a merchandising concern does not create "form utility".

The income of a merchandising concern is arrived as follows:

SALES REVENUES:

Gross Sales		£ 935,000
<u>Less:</u> Sales returns and allowances	£ 16,200	
Sales discounts	13,400	<u>29,600</u>
Net Sales		£ 905,400

COST OF GOODS SOLD:

Beginning merchandise inventory		£ 89,000
Purchases	£ 545,500	
Transportation-in	<u>63,300</u>	
Delivered cost of purchases	£ 608,800	
<u>Less:</u> Purchase returns + allowances	(18,300)	
Purchase discounts	<u>(12,100)</u>	<u>578,400</u>
Goods available for sale		£ 667,400
<u>Less:</u> Ending merchandise inventory		68,000
Cost of goods sold		<u>599,400</u>

GROSS PROFIT ON SALES £ 306,000

OPERATING EXPENSES:

Selling expenses	£ 63,000	
General & administrative expenses	<u>81,000</u>	<u>213,000</u>

OPERATING INCOME

Other revenue	£ 14,500	
Other expenses	<u>(2,500)</u>	<u>12,000</u>

NET PROFIT BEFORE INCOME TAXES £ 105,000

If the cost of goods sold, operating expenses and other expenses exceed the revenue from sales and other revenue, the result will be a net loss.

A Manufacturing Concern: The method of arriving at the gross and net profits of a manufacturing concern is not altogether different from that of a trading or merchandising concern. There is some difference only in the cost of goods sold section of the Profit and Loss Statement. Two variations are prominent: cost of goods manufactured replaces purchases, and finished goods inventory comes in for the merchandise inventory. In a manufacturing concern, instead of one inventory there are three inventories as under:

- (i) Raw materials inventory
- (ii) Work-in-process inventory
- (iii) Finished goods inventory

The cost of goods manufactured is arrived as follows:

It should not be assumed that the account shown as net profit is the same in all cases. This account may be reported to a great extent, in the case of a sole proprietorship. But in the case of a partnership, and particularly in the case of joint stock companies, where there are many owners, many adjustments and appropriations are needed before the profit is divided amongst the owners. As it is already pointed out, in accounting, a business is considered an entity (a specific unit) and the affairs are distinguished from those of the owners. Besides,

<u>WORK-IN-PROCESS INVENTORY (BEGINNING)</u>	£ 20,000
<u>COST OF MATERIALS USED:</u>	
Beginning raw material inventory	£ 30,000
Purchases	£ 61,000
Transportation-in	<u>2,100</u>
Delivered cost of purchases	£ 63,100
<u>Less:</u> Purchase returns + allowances	(400)
Purchase discounts	(100)
	<u>62,600</u>
Cost of material available for use	£ 92,600
<u>Less:</u> Ending raw material inventory	<u>34,000</u>
Cost of material used	£ 58,600
<u>DIRECT LABOUR</u>	39,200
<u>MANUFACTURING EXPENSES</u>	<u>34,700</u>
<u>TOTAL MANUFACTURING COST</u>	<u>132,500</u>
<u>TOTAL WORK-IN PROCESS DURING YEAR</u>	£152,500
<u>Less:</u> Work-in-process inventory (ending)	<u>27,500</u>
<u>COST OF GOODS MANUFACTURED</u>	<u>£125,000</u>

It should not be assumed that the amount shown as net profit becomes the personal property of the owner of owners as the case may be. This notion may be correct to a great extent, in the case of a sole proprietorship. But in the case of a partnership, and particularly in the case of Joint Stock Companies, where there are many owners, many adjustments and appropriations are needed before the profit is divided amongst the owners. As it is already pointed out, in accounting, a business is considered an entity (a specific unit) and its affairs are distinguished from those of its owners. Besides,

a company possesses separate legal entity.

Consequently, it is now intended to take up the treatment of the figure referred to as net profit above, in a sole trading concern, a partnership firm and a joint-stock company.

4.4 ACCOUNTING TREATMENT OF PROFITS IN SOLE TRADING CONCERNS

The oldest type of business unit is that of the sole proprietor - the "one man" business. As recently as the eighteenth and the early nineteenth centuries most manufacturing businesses were of this type, and even today, though large-scale production has made it increasingly difficult for individuals to set up in business for themselves, there are still a few people who succeed in doing so. At the present day the retail trade is probably the easiest to enter for a man with a little capital who wishes to be his own employer.

The profit or loss of a sole trading concern is arrived at in the ordinary manner, discussed above. The balance of profit or loss, as the case may be, is transferred to the proprietorship account. Suppose the profit and loss account of a sole trader, Mr. X, shows a credit balance of Shs. 1,000/- at the end of the fiscal period. This will be transferred to the capital or proprietorship account by means of the following journal³⁵ entry:

Profit and Loss a/c	DR. 1,000/-	
To Mr. X. Capital		1,000/-

On the other hand, if the profit and loss account shows a debit balance of Rs. 1,000/-, the following journal entry will be made:

Mr. X. Capital	DR. 1,000/-	
To Profit and Loss a/c		1,000/-

4.5 ACCOUNTING TREATMENT OF PROFITS IN PARTNERSHIP FIRMS

When two or more persons decide to form and run a business for the purpose of earning profit, a partnership comes into being. To put it into legal terminology, "partnership is the relation which subsists between persons carrying on a business in common with a view of profit."

If the partnership deed does not contain any provision contrary to it, the profits and losses will be shared equally by all the partners irrespective of their individual investment in the business and service. The partners, however, can agree to some other ratio for the sharing of profits and losses in order to compensate some partners for their services to the business, for their investment, or for some other consideration.

The profit or loss for the period is arrived at in the usual manner described in the above analysis. The balance

of profit or loss is transferred to an account called Profit and Loss Appropriation Account where adjustments, if any, are made and the balance is distributed amongst the partners in equal or some agreed upon ratio.

Suppose the Profit and Loss Account shows a credit balance of Shs. 7,500/- to be distributed among partners A, B and C, equally. If no adjustments regarding interest on capital, interest on drawings, and partners' salaries, etc. are to be made, the following journal entries will have to be made:

Profit and Loss a/c	DR. 7,500/-	
To Profit & Loss Appropriation a/c		7,500/-
Profit & Loss Appropriation a/c	DR. 7,500/-	
To A Capital		2,500/-
To B Capital		2,500/-
To C Capital		2,500/-

Sometimes instead of one, two proprietorship accounts are opened for each partner i.e. the Capital and the Personal Accounts. The Capital Account remains fixed. The profits are transferred to the personal account where all adjustments are made and the balance is carried on the books of account along with the Capital Account.

Some issues peculiar to Partnership: It will be appropriate here to take up some of the issues which are peculiar

with the partnership and for which adjustments are required:

(a) Salaries to the Partners: In a partnership firm, where there are numerous partners, not all of them take active part in the management of the business. In fact, all of them cannot take part. In order to compensate the active partners for the time and energy they devote to the business, generally a fixed amount of salary is granted. The salary paid to a partner is not to be treated as an operating expense, like the salaries paid to the staff and the wages paid to the labourers. Partners' salaries are treated as a distribution of profit earned by the business. Out of the profits, first the salaries of the partners (as well as interest on capital brought by the partners) is paid. If anything remains, that is distributed amongst the partners in their profit and loss sharing ratios.

(b) Interest on the Capital of the Partners: Sometimes, when there is unequal contribution by the different partners towards the capital of the business, interest at a fixed rate is allowed to the partners on their respective capital balances. Like the partners' salaries, interest on capital is treated as a distribution of profits, and not as an operating expense.

(c) Interest on the Drawings of the Partners: Sometimes, to reward the partners who withdraw nothing or a very nominal amount, interest at a fixed rate is charged on the individual drawings of the partners. Interest on drawings is not treated as an income of the business, but is utilized in the distribution of the profits. The interest on drawings is deducted from the respective share in the income of the partners.

From the above, it will be evident that the treatment of partners' salaries, interest on capital and interest on drawings is restricted to the Profit and Loss Appropriation Account. The following example will make it clear:

A, B, and C, are partners sharing profits and losses equally. Their capital are Shs. 15,000/-, Shs. 12,000/- and Shs. 10,000/-, respectively, and they have withdrawn Shs. 2,500/-, Shs. 2,000/-, and Shs. 1,500/- during the year. The profits of the year are Shs. 16,910/-. Interest @ 4% is charged on the drawings and interest @ 5% is allowed on the capital. A and B are entitled to an yearly salary of Shs. 4,200/- and Shs. 2,100/- respectively.

The Profit and Loss Appropriation Account will appear as follows:

A. B. and C.

Profit and Loss Appropriation Account
for the year ended 31st December, 19...

Shs.	Shs.
Partners' Salaries:	Profit transferred 16,910
A - Shs. 4,200	from Profit and
B - Shs. 2,100	Loss a/c
5,300	Interests on Drawings:
Interest on Capital:	A - (4% of 2,500) 100
A - (5% of 15,000) 750	B - (4% of 2,000) 80
B - (5% of 12,000) 600	C - (4% of 1,500) 60
C - (5% of 10,000) 500	240
1,850	
Profits:	
A - 3,000	
B - 3,000	
C - 3,000	
9,000	
Shs. 17,150	Shs. 17,150

4.6 ACCOUNTING TREATMENT OF PROFITS IN JOINT-STOCK COMPANIES

The partnership owed its existence as a form of business enterprise to the need for a greater amount of capital than the sole proprietor could supply. The joint-stock company developed out of the partnership for precisely the same reason. Efficiency of production and distribution in many industries requires more capital than can be obtained by a single proprietor

or a partnership. The large amounts of capital needed for successful entry into many fields of businesses are most easily acquired by selling stock (units of corporate ownership) to the public. The distinctive feature of the joint-stock company is that a large number of people provide the capital in varying amounts and receive shares in the profits (if any) in proportion to the amounts they have invested in the company. In this way it becomes possible to raise large sums, providing the sponsors of a proposed new company can persuade the public that its prospects are well founded.

Income of a company is determined in the usual manner described previously. Since ownership and control are separate in a company, the cost of managing the business forms a part of operating expenses. The profit or loss determined by the preparation of Profit and Loss Account or Income Statement is transferred to the Profit and Loss Appropriation Account which is called the Retained Earnings Statement or the Earned Surplus Statement. Any previous balance of Earned Surplus is added to it. In accordance with the decisions of the Board of Directors, all sorts of appropriations are made in this statement. The balance remaining after the creation of various reserves, provisions and declaration of dividends is carried on the books of account in the capital section of the Balance Sheet.

For a number of years two somewhat different concepts of income reporting have been prominent in both accounting practice and literature. Usually they are referred to as the current operating performance concept and the all-inclusive concept. They differed in that certain items which would appear on the retained earnings statement rather than on the income statement under the current operating performance concept would be reported on the income statement under all-inclusive concept. These items were principally material extraordinary or non-recurring gains and losses and corrections of net income of prior periods. Implementation of both concepts is to be found throughout practice.³⁶ In the United States of America, the controversy between supporters of these opposing views virtually ended with the issuance of APB Opinion No. 9, which, in essence, required use of the all-inclusive concept in the reporting of net income.³⁷

4.7 PROFITS IN JOINT-STOCK COMPANIES: DISTRIBUTABLE PROFITS

The object of the formation of most limited companies is the earning of profit; when that object is attained, those who have provided its capital will desire to participate in such profits, by distributions in the form of dividends. By "distributable profits", we mean the profits that a joint stock company can legally distribute to its shareholders in the form of dividends.

In the case of sole traders and partnerships, when any profits arise it would appear that they may be distributed to the proprietors without any question as to their rights to do so. The proprietors have subscribed the capital of the business concerned and those who deal with them should act under the principle of "caveat emptor" (literally, "let the buyer beware", but as a principle for creditors and others, "let those who deal with them look to their own interests"). In the case, however, of limited companies, where the wider field of the public at large and shareholders is concerned, the courts are prepared to ensure that the rights of the various parties are protected. Creditors and other third parties, as well as minority interests, have sought the aid of the courts quite frequently when they have considered their rights to be infringed by acts concerning the distribution of profits.

From what we have said above, if we examine the question as to what profits a company may distribute we are concerned with the aspects of legality (and expediency). Considering the legal aspects, it is a fundamental rule of company law that "dividends shall not be paid otherwise than out of profits." A regulation in these terms is contained in Table A (clause 91) of the Tanganyika Companies Ordinance, 1952.³³ This regulation is applicable to all companies and restricts the dividends to be paid only out of

profits. Even if this clause be specifically excluded by a company's articles which are otherwise silent on the matter, the position is the same. Moreover, any attempt to override this established rule by the inclusion in the memorandum or articles of express authority to pay dividends otherwise than out of profits or to seek such power by special resolution would (apart from the special circumstances mentioned later) be of no avail, since this would involve a reduction of capital.

The law rigidly preserves the sanctity of capital, mainly for the benefit of creditors and this is an overriding obligation imposed upon all companies as one of the conditions to be satisfied for the benefits derived from incorporation.

The question then arises: "what are profits for this purpose?" The term "profits" is capable of varying shades of meaning when used in different contexts.

Generalization is not useful in this connection, but subject to the several important qualifications discussed later, it may be said in general that if the total of the assets in a balance sheet (after proper provision has been made for depreciation) exceeds the total of the paid-up capital, capital reserves and liabilities, the excess may be regarded as profit available for dividend.

We have certain guides in determining distributable profits. In deciding about the amount available for dividends, we must keep three things in mind:

- (i) the principle laid down by Regulation 91 of the Table A, that no dividend can be paid otherwise than out of the profits;
- (ii) the various judgements involving profits, that is, the legal decisions by various courts on the term profit, pointing out what can legally be included in the profits available for dividends and what losses must be made good while arriving at the figure of distributable profits. One legal definition of profit has already been given in chapter two. Some of the leading cases along with the decisions laid down therein have been dealt with in this chapter.
- (iii) the provisions of the Memorandum and Articles of Association of a particular company.

Recently, the government of Tanzania worried about the amounts of foreign exchange flowing out of the country in the form of dividends, passed the Companies (Regulation of Dividends and Surpluses and Miscellaneous Provisions) Act, 1972.³⁹

Section 7(1) of the Act concerning "Imitation on Dividends" is mentioned later in the chapter.

4.7.1 Some Legal Judgements about Distributable Profits

Revaluation of Assets: Profits may arise during the course of the life of business other than those directly concerned with its actual trading, for example, in connection with disposal of its fixed assets. Such profits may be realized or take the form of book figures only created by such matters as revaluation. Are such profits to be regarded as a surplus on capital account, or may they be treated as profits available for distributions to shareholders? To justify the latter the surplus must:⁴⁰

- (a) accrue from the revaluation of the assets as a whole and not from selected assets or an isolated asset, since an accretion in the value of one or more assets may be counter balanced by a contraction in the value of others;
- (b) be a realized surplus, i.e. resulting from a disposal (but see later), and,
- (c) not be subject to any regulation in the articles prohibiting a distribution.

In Lubbock v. The British Bank of South America Ltd.,

(1892)⁴¹ the foregoing conditions were satisfied and it was held that the directors were justified in distributing the profit by way of dividend.

This case was brought by a shareholder against the company in order to ascertain the legal position with regard to the proposal to distribute certain capital profits. These had arisen on the sale by the bank of its assets and liabilities in Brazil, agreeing as it did so to discontinue operating there. It subsequently re-purchased rights to operate its original branch and a profit arose on the whole transaction of some £ 205,000. The Articles of the company permitted the carrying of such profits to the profit and loss account and the distribution of dividends subject to passing a necessary resolution.

It was held that the profit was a sum in excess of the capital and not part of the capital itself and as the Articles so permitted, it was distributable.

A contrary decision was given in the case of Forster v. the New Trinidad Lake Asphalt Co. Ltd., (1900).⁴² In this case, the company took over along with other assets, a book debt of £ 100,000 secured by promissory notes from another company. The debt was at that time considered to be valueless, and, as such, not shown as an asset in the books of the company.

But subsequently, it realized £ 26,000 and the directors proposed to distribute this amount as dividend treating it as capital profits available for dividend.

It was held that the amount received in respect of the debt was a capital profit, but not necessarily a divisible profit; dividends may be paid out of earned profits despite a depreciation of capital, but a capital profit may be distributed only if such profit exists after reference to the whole accounts fairly taken. In other words, in this case an injunction was obtained against the directors restraining them from treating as profit available for dividend the realized accretion to the value of one item of the capital assets without reference to the result "of the whole account taken fairly."

Until 1961 it had been accepted that any profit on the disposal of an asset must satisfy the foregoing three conditions if it is to be distributed, but a case that was decided in that year, Dimbulla Valley (Ceylon) Tea Co. Ltd., v. Laurie (1961),⁴³ gave rise to some doubt relative to condition (b). In this case the preference shareholders raised objections to the capitalization of unrealized reserves. It was held that if the articles specifically authorize the distribution of a capital surplus this may be done if the profit is not realized in cash, provided liquid resources are available to pay a dividend. Although Buckley, J. sought to justify this decision in

a lengthy dictum, he was careful to add, "I do not say that in many cases such a course of action would be a wise commercial practice, but for myself I see no ground for saying that it is illegal."

Instead of an accretion to the value of fixed assets there may be contraction, but this does not necessarily preclude a company from distributing an earned surplus on revenue account.

In the case of Verner v. the General and Commercial Investment Trust Ltd., (1894),⁴⁴ the capital value of some of the company's investments had fallen considerably, and the company proposed to pay a dividend without providing for the obvious depreciation of its main assets. The aid of the court was sought to restrain the company from carrying out its proposal. The injunction was refused, as it was held that the company was solvent and acting within its Articles.

In the words of Lord Justice Lindley,

"The word 'profit' is by no means free from ambiguity. The law is much more accurately expressed by saying dividends cannot be paid out of capital than by saying that they can only be paid out of profits. Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost and yet the excess of current receipts over current payments may be divided....."

...Floating or circulating capital must be kept up as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law." (45)

In certain cases, it may be permissible for a company to pay dividends out of current profits and making good a debit balance on profit and loss account occasioned by losses in previous years, there being nothing to prevent a company writing off such losses out a genuine appreciation in the value of capital assets.

A case which exemplifies this is Ammonia Soda Co. Ltd., v. Chamberlain, (1918).⁴⁶ The company, having sustained losses on revaluation of its land, created a reserve account and wrote off a proportion of its adverse profit and loss account, the remaining proportion was written off subsequently out of current profits.

Preference dividend were paid, but it was contended that in so far as the whole of the debit balance on the profit and loss account had not first been written off out of current profits, there had been a payment of dividends out of capital.

The Court of Appeal rejected this contention, Swingen, L.J. stating:

"The Companies Acts do not impose any obligation upon a limited company nor does the law require it, that it shall not distribute as dividend the clear net profit of its trading unless its paid-up capital is intact, or until it has made good all losses incurred in previous years." (47)

Legal Aspects of Depreciation: The legal aspect of depreciation is closely bound up with the consideration of profits and the amounts which may be properly used for distribution purposes.

It sometimes happens that a company is formed to acquire a concession for obtaining mineral products, bituminous rock, sand or gravel and when the concession has been fully worked, the company goes into liquidation. In such circumstances the company may (subject to requisite powers in the Memorandum or Articles) distribute in the form of dividends each annual surplus on revenue account without any provision for depreciation of wasting assets or the renewal of any lease. In Lee v. Newchapel Asphalte Co., (1889),⁴³ the company's main asset consisted of a concession to mine a bituminous substance in Switzerland. The company had been formed specifically to acquire and work the asset and a clause had been inserted in the Articles stating that no provision for depreciation or wastage of fixed assets need be made before payment of dividends. An ordinary shareholder sought the aid of the court to restrain the payment of a dividend on the preference shares.

It was held that a company may, by its Articles, provide for the distribution of profits before making good the depreciation of fixed assets.

This decision should be used cautiously, as it is clearly against sound commercial policy. Any operation which purposely consumes capital in the process of profit distributions is clearly unsound. It can only be justified in those rare cases when the circumstances are exceptional, when adequate powers for distribution are taken in the memorandum and articles and when all reasonable steps are taken to ensure that members, long-term creditors and the investing public are made aware of what is happening.

Bolton v. Natal Land and Colonization Co. Ltd., (1892)⁴⁹

In 1882, the company appreciated the value of land and credited the profit and loss account with a view to offset a loss due to a bad debt, in that year. In 1885, current profits were made and a dividend was then paid out of these profits. The plaintiff maintained that the value of the land had depreciated much in value. As such the profit and loss account should be debited before arriving at the profit.

It was held that despite the fact of there having been no justification for the writing-up of the land, and that it was excessively valued in the accounts, following the decision in Lee v. Newchattel Asphalte Co. Ltd., it was not illegal

to distribute the current profits without making any adjustment for the loss of the capital.

If such unrealised appreciations are taken into account while depreciations are ignored, the true financial position cannot be ascertained.

Depreciation provided in the past may be written back to revenue provided it is in excess of the amount required as at that date. (Stapley v. Read Bros. Ltd., (1924)).⁵⁰

The foregoing special considerations arise out of exceptional circumstances in each case and must not be taken necessarily to violate the general principle that dividends are payable only out of a revenue surplus.

4.7.2 Conclusions Regarding Distributable Profits

After examining the above and some other judgements Batliboi has drawn the following conclusions about distributable profits:⁵¹

- (a) A dividend pre-supposes a trading profit or a surplus but in certain cases, divisible profits may include profits of a capital nature.

- (b) The company law does not require a company to maintain its capital intact, but merely forbids any part of the capital to be returned to its shareholders.
- (c) Neither the sanction of a General Meeting nor an express authority in the Memorandum or the Articles can justify the payment of a dividend out of capital.
- (d) The question of how "Divisible Profits" should be arrived at is left by law for each company to decide for itself with due regard to the nature of its business and the regulations governing it.
- (e) If a company paid dividends in any one year out of a credit balance on Profit and Loss Account of that year properly arrived at, then such dividend is not paid out of Capital.
- (f) Depreciation or Loss on Floating or Circulating Assets must always be made good before the payment of a dividend.

- (g) Depreciation of Fixed Assets need not necessarily be provided for before the payment of a dividend; but as to whether such a provision is necessary or not will be a question of fact to be determined by the court, with due regard to the nature of the company's business, the regulations of the company concerned, and other circumstances.
- (h) In the case of a manufacturing concern, due provision must be made for Depreciation of Plant and Machinery before ascertainment of divisible profits.
- (i) Unless so required by its Articles, a company formed to work a wasting asset need not necessarily provide for depreciation of such asset before arriving at divisible profits.
- (j) Any provision in a company's Articles requiring depreciation or particular losses to be made good prior to ascertainment of divisible profits are valid and binding, and must be strictly followed.

- (k) Whether it is necessary or not for a company to replace capital previously lost before distributing the current profits, depends entirely on the company's own regulations; but the company must retain sufficient assets to enable it to pay off its debts and liabilities while declaring dividends.
- (l) Assets may be revalued, provided it is done honestly and with the approval of the shareholders. An asset that may have been over-depreciated in the past may be written up, and the surplus thus arising may be utilised in writing down another asset, in order that the book value of each may be brought nearer the present value.
- (m) Capital profits, if realised, may be distributed as dividends, unless the Articles forbid such a procedure, but in such a case, the credit of the Profit and Loss Account must be specifically shown so that it may not be mistaken for trading profit.
- (n) Any appreciation in the value of the fixed capital of a Limited Company can only be distributed, if after a re-valuation of all the assets and liabilities of the company, there is a distinct surplus over

the capital; it is equally necessary to see that such capital profit is realized in cash, and the regulations of the Company do not prohibit such a distribution.

- (o) Directors authorising the payment of a dividend out of capital are guilty of a breach of trust, and are jointly and severally liable to repay the amount.
- (p) Directors and auditors who help in the declaration of a fictitious dividend by the publication of false accounts are criminally liable.

4.7.5 The Companies (Regulation of Dividends and Surpluses and Miscellaneous Provisions) Act, 1972

In 1972, the government of Tanzania passed the above Act. Section 7(1) of the Act concerning "Imitation of Dividends" is given below:

"No company, whether or not a specified company shall in respect of any financial year, declare dividends the aggregate sum of money payable in respect of which -

- (a) exceeds the sum of money which when deducted from the company's net worth in respect of such financial year will have the effect of reducing such net worth to a sum of money which is less than one hundred and twenty-five per centum of the par value of the company's paid up ...

...share capital as to the close of such financial year; or

(b) exceeds the largest of the following sums of money, namely -

(i) the average of the annual profits of such company during the three financial years immediately preceding such financial year; or

(ii) eighty per-centum of the profits in the financial year immediately preceding such financial year; or

(iii) where the company first commenced its business immediately before or during such financial year, eighty per centum of its profits in such financial year." (52)

In August 1972, the government of Tanzania passed the SPECIFIED COMPANIES (FURTHER LIMITATION ON DIVIDENDS) ORDER. The

Order read:

"No specified company, shall declare dividends in respect of the current financial year or any subsequent financial year, the aggregate of which exceeds twenty per-centum of such company's approved net worth." (53)

The appendix which consists of an actual case study in the Tanzanian environment shows the effect of the application of the above regulation concerning limitation of dividends on a certain company in Tanzania - Simba Tours and Lodges Limited. In this case, we shall see /Section 7(1) of the Companies Act, / that 1972, described in verbal form above, has been spelled out in procedural form, and applied to a real problem.

4.8 DIVIDENDS

Dividends may be defined as a prorata distribution by a Corporation to its shareholders.⁵⁴ In the present day world, the main concern of an average investor is dividend, as it is the remuneration or reward for his investment. The profits of a company are distributed to its owners (i.e. shareholders) through dividends.

Dividends may be classified into the following kinds:

1. Cash Dividends: Cash dividends are most common in this country. In fact, when one speaks of dividends only, he refers to cash dividends. Cash dividends implies cash return to the shareholders. While accounting for a cash dividend, decrease in earned surplus (Retained Earnings) and cash must be recognised. The following specimen entries will make it clear:⁵⁵

Retained Earnings	DR £ 15,000	
To Dividends Payable		£ 15,000
Dividends Payable	DR £ 15,000	
To cash		£ 15,000

The general requirements for payment of a cash dividend include (i) existence of retained earnings, (ii) an adequate cash position, and (iii) action by the board of directors.

2. Property Dividends: Most dividends are in cash but occasionally a company may choose to pay a dividend in the form of merchandise, or other property such as securities of another company. In most cases of property dividends, the book value of the assets being distributed is the appropriate amount to be recorded as a dividend rather than the current market value of such assets. The retained earnings of a corporation reflects the values at which assets are carried on the books. If some of these assets are distributed to shareholders as a property dividend, retained earnings is reduced by the book value of the assets so distributed.

The following journal entries will record the Property Dividends which are in the form of securities of another company:

Retained Earnings	DR £ 15,000	
To Dividends Payable in shares of A.B.C. Co. Ltd.,		£ 15,000
Dividends payable in shares of A.B.C. Co. Ltd.,	DR £ 15,000	
To investment in A.B.C. Co. Ltd.,		£ 15,000

3. Scrip Dividends: When the dividend is paid in the form of notes payable, usually interest bearing, it is called a Scrip dividend (liability dividend). Scrip dividends

are resorted to when a company has adequate retained earnings balance but no cash and does not expect to get cash in the near future. The shareholders can discount the notes if they need cash, or wait till the maturity date to receive the full amount of the note as well as the interest.

The accounting entries for a scrip dividend would be:

Retained Earnings	DR £ 15,000	
To Scrip dividends payable		£ 15,000

If a note is payable after six months along with 6% interest, the following journal entry will be made at the time of payment:

Scrip dividends payable	DR £ 15,000	
Interest Expense	DR 450	
To Cash		£ 15,450

4. Stock Dividends: A stock dividend is a distribution of additional shares to the stockholders in proportion to their existing holdings. "Common on Common" is the usual type of stock dividend; such a distribution is also known as an "ordinary stock dividend".

Distribution of a stock dividend causes no change in the assets or liabilities of a company; the only effect is a transfer

between accounts in the stockholders' equity group. Since there is no decrease in the net assets of the company, a stock dividend does not give the stockholder anything he did not have before. The number of shares held by each shareholder is increased but each share represents a smaller slice of ownership in the company. The net assets of the company are unchanged by a stock dividend and the proportionate interest of each stockholder in those assets is unchanged.

In the case of stock dividends, the following journal entries will be made:

Retained Earnings	DR £ 15,000	
To Stock Dividends payable		£ 15,000
Stock Dividends payable	DR £15,000	
To share capital		£ 15,000

When a company has adequate earned surplus balance but no cash, stock dividend is one of the alternatives generally adopted.

5. Optional Dividends: Sometimes the shareholders are given an option either to accept a cash dividend or a stock dividend. The dividends of this sort are called optional dividends.

6. Debenture Dividends: Sometimes a company issues debentures for dividends. Such dividends are called debenture or bond dividends. Debenture dividends are issued when a company has adequate earned surplus balance but no cash, and there is no hope that cash will be available in the near future. Since debentures are long-term liabilities, the company can avoid the payment of cash for a number of years. The shareholders, however, are at liberty to sell debentures whenever they need cash before the maturity date. The entries for recording debenture dividends are as under:

Retained Earnings	DR £ 15,000	
To Dividends payable in debentures		£ 15,000
Dividends payable in debentures	DR £ 15,000	
To 5% 10-year debentures		£ 15,000

7. Liquidating Dividends: When a portion of the original investment of the shareholders is returned, it is called a liquidating dividend. In this case, instead of debiting the share capital, a new account is generally opened, which is subsequently deducted from the share capital of the company. Such dividends represent the recovery of the cost of investment for the shareholders.

The companies which own wasting assets, pay dividends which are partly out of earnings and partly out of share capital. The amount of dividends need proper apportionment in such a case.

Various Types of Shares and Dividends: There are several types of shares, the important ones being Ordinary, Preference and Deferred. Though it is not within the scope of the thesis to deal with the classes of shares in detail, it may be pointed out that the preference shareholders get priority over the other classes in respect of dividend payments. A preference as to dividends does not give positive assurance that dividends will be paid, it signifies merely that the stated dividend rate applicable to the preferred stock must be paid before any dividends can be paid on the common stock. If the preference share is non-cumulative, the shareholders cannot claim arrears of the dividend in future if in one year the earnings do not permit the dividend declaration. In the case of cumulative preference shares, the shareholders get the arrears. After the preference shares, ordinary shareholders are paid dividends and lastly the deferred shareholders. Preference shares carry a fixed rate of dividend, but if they are participating they share the surplus remaining after the payment of dividends on ordinary and deferred shares.⁵⁶

Declaration of Dividends: The authority for declaring dividends rests in the directors of the company. No obligation to pay a dividend exists until the board of directors has formally declared a dividend. This dividend action by the board consists of a resolution specifying the following points:

- (i) Date of declaration;
- (ii) Date of record;
- (iii) Date of payment;
- (iv) Rate or amount per share.

Generally the Articles of most companies contain provisions as to how profits should be distributed. However, the company in General Meeting may declare dividends; the dividend shall not exceed the amount recommended by the directors. According to clause 91, dividends shall not be paid out of profits. If the directors do not deem it fit to declare dividends in any year, the shareholders cannot claim the same as a right. If the directors pay dividends out of capital, action can be taken for the recovery of the whole amount from the directors.

In short, it can be said that while declaring dividends the directors should keep in mind the legal provisions as well as the financial implications of the dividends. By legal provisions we mean the following:

- (i) The dividends must be paid out of earned surplus.
- (ii) Dividends should not be paid when it means impairing legal capital.
- (iii) Dividends should not be paid when the company is insolvent or solvency of the company is threatened.
- (iv) Restriction on dividends imposed by creditors or the Government if any, should be kept in mind.

Besides, the Directors must make sure that:

- (i) Adequate working capital is left over after paying off the dividends, for meeting other needs.
- (ii) Some balance of earned surplus is left over after the payment of the dividends, for critical days.
- (iii) Earnings are retained for:
 - (a) Financing business growth
 - (b) Reducing liabilities
 - (c) Stabilising earnings, etc.^{56a}

4.9 WHY ACCOUNTANTS USE THE HISTORICAL COST PRINCIPLE

The primary argument for historical cost valuation is that it is objectively determinable. That is to say, acquisition cost is objectively determined in the market place by rational buyers and sellers acting in arm's-length transactions (no collusion). Consequently, acquisition cost is not subjectively

determined by accountants, but is a bargained-purchase price objectively determined in the market place.

Based on the objectivity argument as a foundation, other arguments for historical-cost valuation follow. For example, it is argued that acquisition cost has the advantage of approximating value at the time of purchase, since it is a market-determined purchase. It is also argued that historical-cost valuation is verifiable by accountants, because it can be tested in the market place. Also, since historical-cost valuation is based on actual purchases, it is argued that such valuation results in financial statements that are less subject to dispute than those using other proposed valuation methods based on hypothetical purchases (replacement costs) hypothetical sales (current selling price), or subjective estimates of future prices (discounted amount).⁵⁷

A frequent argument for historical-cost valuation is that it provides useful financial information for financial decision-making, in that, knowledge of the past is necessary to predict the future. Consequently, it is contended that historical-cost data provide useful information for making comparisons for trend analysis, for intracompany analysis (cost comparison among departments), and for intercompany analysis, as well as for comparisons with current-cost data.

Professor Ijiri argues that historical-cost valuation provides an automatic control feature that is missing in other proposed valuation methods.⁵⁸ That is to say, historical-cost valuations structured on the double-entry book-keeping system result in recording changes in the entity's resources by linking together the inputs and outputs so that they can be traced and identified whenever necessary. Thus investors and creditors can rely on the existing accounting system to control the resources of a firm (custodianship function of accounting) in a manner that they can trust to protect their interests.

From a practical point of view, it is argued that cost is convenient to obtain, it is conservative, and it is closely related to and consistent with the revenue-recognition (realization) principle.

Because of these reasons, the subjectivity and impracticality of other valuation methods, and the precedence of acquisition cost in the legal system, historical cost is the normal valuation method used by practicing accountants.

CHAPTER FIVE

ACCOUNTING PROFIT MEASUREMENT: THE ALTERNATIVES

In this chapter we shall outline an alternative measure of profit to that currently offered in financial reports. The alternatives discussed will be within Accrual Accounting e.g. different valuation methods - Historical versus current. In attempting this task, we shall also refer to the economic concepts of income and value. The main variations are illustrated in Figure 5.1

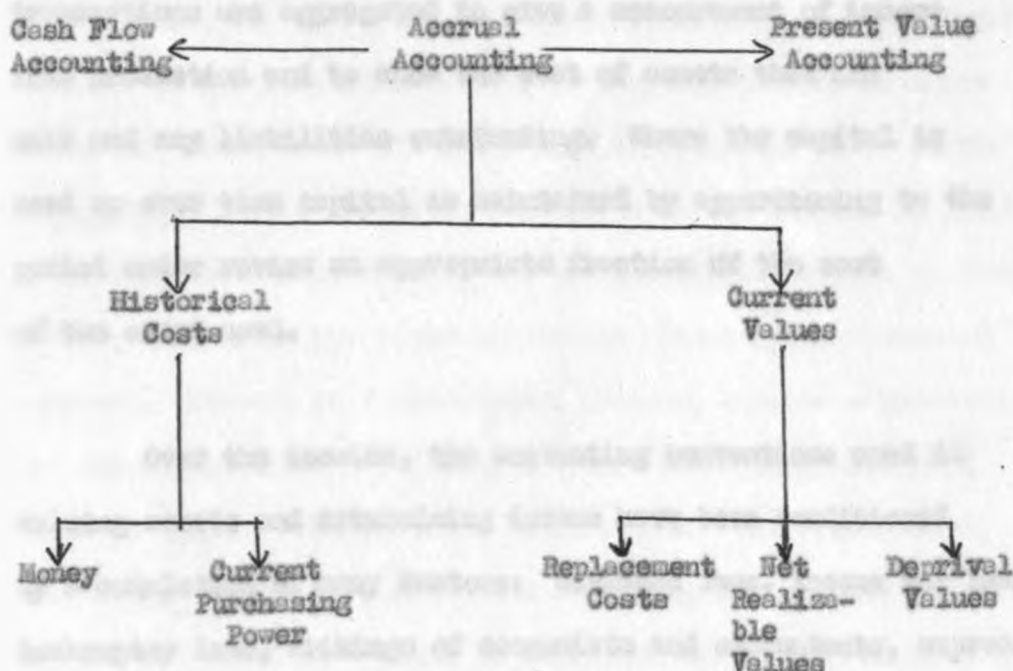


Figure 5.1: Alternative Measures of Profit

In chapter four we discussed the accounting concept and measurement of profit. We talked of cash flow Accounting versus Accrual Accounting and saw why Accrual Accounting was preferred to cash flow accounting. In present accounting practice - money historical costs based on accrual accounting -, the ultimate source of the reports which constitute the output of a firm's accounting system is a book-keeping record of the exchange transactions in which the firm has engaged. All transactions are recorded at the time they take place and in terms of the money sacrificed or received in exchange for capital goods. At the end of the accounting period the transactions are aggregated to give a measurement of income from production and to show the cost of assets that are held and any liabilities outstanding. Where the capital is used up over time capital is maintained by apportioning to the period under review an appropriate fraction of the cost of the asset used.

Over the decades, the accounting conventions used in valuing assets and determining income have been conditioned by a cumulation of many factors: dividend laws, income tax laws, bankruptcy laws, writings of economists and accountants, expressed needs of financial analysts, and the like. For good or bad reasons, accountants have evolved the related concepts of "realization" and "historical costs", which have a firm grip on present day accounting practice. Critics, however, have questioned the relevance of historical cost in the context of constantly

changing prices, while also asking whether accounting can continue to ignore the changing purchasing power of the monetary unit.

The present approach to accounting profit measurement and asset valuation has been condemned for many years. Before we see why it is considered inadequate, we must point out one of the main problems encountered in accrual accounting and which would still remain a problem within whatever alternative we choose within the accrual accounting framework mentioned above.

While the measurement of revenues is not always a simple task, it is far more difficult to measure the process by which assets are consumed in the production of revenues. Some degree of jointness in the use of assets exists in all but the simplest of enterprises. Nonetheless, the accountant is expected to find a way of measuring the costs associable with a given amount of revenues. Because this measurement process, like so many which the accountant uses, inevitably involves human judgement such terms as "fair", "reasonable", "appropriate", and "equitable", frequently intrude in discussions of alternative approaches. Because of the usual absence of objective evidence to support the validity of any one method in preference to the others, for measuring the costs associable with a given amount of revenue, the methods are all arbitrary. This allocation problem will still have to be encountered, whatever alternative we choose within accrual accounting.

5.1 SOME LIMITATIONS OF HISTORIC COST MEASUREMENT

(a) The matching procedure which is followed in attempting to measure profit causes some revenues and some expenditures to be allocated to time periods other than those in which they cause a cash flow or lead to production. They are carried forward to the next period and appear in the balance sheet as fixed assets, inventory, debtors, creditors, prepayments, accruals, etc. according to their origin. The balance sheet statement of assets and liabilities is therefore a statement of:

- (i) expenditures and revenues which have taken place, but which have not been allocated to an expired time period, e.g. fixed assets, inventory, and advance payments received, and
- (ii) expenditures and revenues which have been allocated to an expired time period but which have not yet taken place, e.g. creditors and debtors.

The balance sheet is therefore not a statement of the values of assets and liabilities, despite its contrary appearance, and despite the general use of the term 'book value' in relation to them, if value is used in either of its usual senses of market value or subjective value. The balance sheet therefore does not

show a meaningful measure of the value of either the capital employed or the capital invested. This is another way of saying that historical cost valuation results in a balance sheet that does not provide useful financial information about current financial position.

Since profit is the measure of the change in the amount attributed to capital during a period, it follows that the income statement does not measure it satisfactorily.

(b) But even as an historical record neither the balance sheet nor the income statement is wholly satisfactory.

The capital employed is calculated by summing the amounts shown in the balance sheet for the various categories of asset, i.e. fixed, current and other, and subtracting the amounts shown as liabilities. These various amounts are calculated by summing the amount shown for narrower classifications, e.g. land, buildings, plant, vehicles, inventory, debtors and cash. Those amounts are the summation of the amounts attributed to the various individual items composing these classifications.

We have seen that fixed assets are usually shown at an amount based on their purchase price which may have been paid 2, 20, 5, or 50 years before. It is probable that, for most types of fixed asset, some purchases will have been made in each of several different years. But of course, prices change continually

over time with changes in the level and distribution of incomes, the pattern of demand, and methods of production, the movement of prices in general being composed of varying movements in the prices of particular goods and services. The measuring rod of accountancy practice, the currency, is thus not stable in its purchasing power. Pounds, dollars, francs, or shillings at different points of time are not the same. A summation of expenditures taking place over a range of time is therefore statistically meaningless. It becomes of less and less practical use as the period of time and the extent of price movements grow greater.

This is only part of the picture. Depreciation, calculated on one or more of a variety of bases (straight line or diminishing balance or service unit or sum of the year's digits, etc.) is deducted from the acquisition price of most types of fixed asset, further obscuring the meaning of the conventional measure of capital employed.

Further, other classifications of asset are measured on different bases. Debtors are shown at the amount which it is anticipated will be collected from them at some future time. The accountant thus looks into the future as well as the past in the same calculation of present capital. In the case of inventory, he may look one way or the other, according to whether his particular cost calculation or the market price is lower. Indeed, if the

cost and market price of each different type of inventory are considered separately, as may be the case, the total measure will probably include both past and future measures. Cash is shown at its present value.

A total produced by summing amounts calculated on such divergent bases is of no use to anyone. Yet every year in the UK, numerous audit reports state that such calculations show a true and fair view of the state of affairs of the company concerned. Every year in the USA numerous reports state that such calculations are prepared in accordance with generally accepted accounting principles.

The same limitation necessarily applies also to the calculation of profit. Expenditures made at varying times are allocated on varying bases against the revenues attributed to a period. The answer may give only a rough approximation of the changes in the company's wealth during the period.

(c) Expenses and assets as measured by general accounting practice are fundamentally similar. Both arise from expenditures. Their amounts depend mutually on the ways in which the expenditures are allocated between periods. As both the profit and capital employed figures depend on this allocation, so does any calculation of the return on capital employed. Such calculations are therefore subject to the shortcomings outlined above. Further problems of interpretation may arise, however, as a formal consistency of

method may conceal differences of substance in the calculations over time, such that their satisfactory interpretation as a trend of results is difficult. Interfirm comparisons may also be difficult to interpret. They are frequently made impossible by the inconsistent methods of expenditure allocation used by different firms.

(d) An advantage claimed for the historical cost basis is that it achieves a much greater objectivity and verifiability than any alternative system. This is thought to be particularly important by auditors. The professional bodies have also been loath to depart from the "objectivity" of historical costs. They have spoken in unfavourable terms about the "personal opinions" that would be introduced into accounting by the abandonment of historical costs. However, historical costs are not as objective as some might think; accounting is already full of "personal opinions". There is much subjectivity in:¹

- selecting depreciation methods and rates;
- deciding on the size of provisions for bad debts, etc.;
- selecting absorption or direct cost methods for manufacturing overheads;
- selecting manufacturing overhead absorption methods and rates;
- treating good will, major repair costs, organisation costs, etc.;

- valuing inventories;
- treating profits on long term contracts;
- accounting for hire purchase agreements and leases;
- deferring taxation charges (if at all);

and so on.

(e) The primary criticism of historical cost valuation is that it results in providing financial information that is irrelevant to making current financial decisions. Historical-cost valuation provides past cost data, whereas financial decision-making should be based on current and future financial data. Financial decision-making models used by informed management, creditors, and investors are not based on historical-cost data.

As we have already said the historical cost system made a good deal of sense in earlier times when ownership and management generally coincided, and when the family owners of an enterprise were more or less irrevocably and permanently committed to a firm as a venture. The historical cost system had the additional advantage that, combined as it is with various other conservative rules, it generally protected the interests of the only main group of outsiders, the creditors.

In today's conditions, where owners typically move in and out of investment fairly rapidly, and where share ownership is widespread and almost entirely divorced from management, the

historical cost basis fails to provide information which is entirely relevant to the needs of users.

Relevance, of course, remains merely a philosophical standard until it is related to the specific environment. The question is what is relevant? Accounting, as an information provider, must present figures upon which rational decision-making can be made. The following decisions are pertinent to accounting data:²

- (a) Decisions of shareholders
 - (i) in their appraisal of management
 - (ii) in respect of their shareholdings
- (b) Decisions of potential investors.
- (c) Decisions of management in their function of manipulation of scarce resources to maximise business goals and of obtaining optimum resource allocation and combination.
- (d) Decisions of creditors, governments and employees in their relationships with the entity.

To submit a statement of financial position as a list of costs not yet charged to revenues, although consistent with the cost model, is, no basis for the formulation of the above decisions. As already mentioned, of what significance is an increase in

"wealth" (income determination) during a period if the figures at the beginning and end of the period themselves do not express wealth at those point of time? While historical cost methods may give some indication to the shareholders of the stewardship of management in the management of costs and money capital under their control, the records give no indication of the real worth of the enterprise as a going concern except to the extent that operating profit is a predictive device. In short, it is a static concept in a dynamic economy with its changing prices.

In information theory, information is something newly apprehended by a decision maker in the context of a decision to be made, and it must be relevant for that purpose. As Billy E. Goetz says:

"At best, irrelevant data are useless;
at worst, irrelevant data can lead
managers into serious error." (3)

In short, when prices are changing (and they are changing), financial reports based on historical costs do not constitute relevant information for decision-making by management, shareholders, intending shareholders, creditors and others. If it is intended that accountants should produce information that is relevant, then notice must be taken of the effects of changing prices. To assume that prices do not change is completely unrealistic. Financial statements prepared on this assumption

misrepresent the true situation and very often result in incorrect decision-making, inefficiencies, and losses of varying kinds.

5.1.1 The Effects of Changing Prices on Conventional Accounting

The following simple examples are designed to demonstrate that conventional accounting procedures produce misleading data when prices are changing, and that something should be done to modify accounting methods if meaningful "information" is to be produced.⁴

Example 1: A taxi is purchased for £ 1000 and it has a life of 5 years. The results in each year were:

Revenues	£ 6,400
<u>Less:</u> Wages and other cash expenses	6,000
= Cash margin	400
<u>Less:</u> average depreciation	200
= Net Profit	<u>£ 200</u>

Five years later the taxi is scrapped (no salvage value) and the balance sheet reads:

Capital	£ 1,000	Cash	£ 2,000
Undistributed profits	1,000		
	<u>£ 2,000</u>		<u>£ 2,000</u>

Suppose that all prices had been rising over the five years and that it now takes the whole cash balance of £ 2,000 to buy an identical taxi (for simplicity let us assume that there have been no technological changes).

We started the 5-year period with a taxi and no cash and we ended the period with an identical taxi and no cash. Are there really any profits? It is not correct to show a profit of £ 1,000 in the balance sheet! Depreciation has been undercharged in each year and on the surface it seems that an unrecorded loss has been incurred in holding cash during the period.

Example 2: In this case we commence a business with capital of £ 2,000 with which we purchased 1,000 inventory items for £ 2 each.

The stock is held for a while and then sold for £ 4,000. Sundry expenses are £ 1,000. Trading for the first period was (in conventional accounting);

Revenue	1,000 @ £ 4	£ 4,000
<u>Less:</u>	Cost of Sales -	£ 2,000
	1,000 @ £ 2	<hr/>
	= Gross Profit	£ 2,000
<u>Less:</u>	Expenses (all cash)	1,000
	= <u>Net Profit</u>	<hr/> <hr/> £ 1,000

However, the purchase cost price of these stock items has been rising steadily and the current cost price at the time of the sale was £ 2.50 each. One thousand stock items are purchased and put back on the shelves at this price of £ 2.50, i.e. out of the proceeds of £ 4,000. The position according to conventional accounting then is:

Capital	£ 2,000	Cash	£ 500
Undistributed profits	1,000	Inventory	2,500
	<u>£ 3,000</u>		<u>£ 3,000</u>

The period commenced with 1,000 inventory items and at the end of the period was in the same position plus £ 500 in cash. That is, the firm is better off by £ 500 cash.

Should not the profit figure be only £ 500 and not £ 1,000? In this case, the cost of the sale was under-charged by adhering to the original historical costs.

Example 3: A company starts off the period with a capital of £ 10,000, all of which is invested in 6% debentures as the time is not yet ripe for the company to proceed with its intended operations. Whether prices rise or fall or remain constant during that year, conventional accounting will show a profit of £ 6,000 for the interest received. If all prices rise by 20% during the year, would it be correct to

still show a profit of £ 600? Assuming that the debentures can still be sold for their face value, should not a loss of £ 1,400 be shown? (That is, the £ 2,000 loss in purchasing power minus the £ 600 interest received).

Here the calculation of the loss on holding monetary items during a period of rising prices is necessary before the true position can be seen.

Example 4: A company is formed to buy and rent freehold land. It buys one piece for £ 10,000 and then prices commence to rise. It buys a similar piece for £ 12,000 after 3 years and then another similar piece for £ 18,000 after 5 more years. The conventional balance sheet then shows:

Capital	<u>£ 40,000</u>	Freehold Land	<u>£ 40,000</u>
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This merely shows a summation of pounds of differing values paid out for land over an 8-year period. The total really means nothing to the shareholders as the current value of the land is £ 54,000 and the real value of their investment is £ 54,000.

If annual net rentals are £ 3,000 the shareholders are probably being misled into thinking that the earning rate is 7.5% ($£ 3,000/£ 40,000$) when the real rate of return is only

5.5% (£ 3,000/£54,000). A clearer picture of the situation would have been obtained if the value of the land had been written up in the accounting system each year, i.e. by using a revaluation reserve account.

The situation becomes worse when we consider a depreciating asset. Here, not only is the denominator understated in the % - return calculation, but the numerator (profit) is over stated because depreciation is calculated, conventionally, on low, out dated cost figures. These two mis-statements of figures combine to produce a larger, incorrect return %.

5.1.2 Some of the Harmful Effects for not Accounting for Price Changes

Here are some of the harmful features of internal and external financial reports and statements based on conventional historical costs. Such reports and statements:⁵

- (a) Overstate profits (because depreciation is understated in these times of rising prices, cost of goods sold are also understated, and losses incurred by holding monetary assets held when prices rise are ignored);
- (b) Undervalue most assets;

- (c) Result thus in the return on capital calculation being overstated;
- (d) Contain incorrect product costings - and hence result in incorrect selling price determinations, wrong decision-making on sales contracts, etc.;
- (e) Result in incorrect evaluations of management and divisional performances (at various levels);
- (f) Can produce incorrect dividend and profit-retention decisions; and
- (g) Often result in incorrect capital expenditure, replacement, make-or-buy, etc. decisions being made through the inclusion of out-of-date historical cost data in the economic analysis carried out.

In view of all this we find that very little progress has been made in the direction of improving the quality of financial information either by adding or substituting more relevant figures to those produced by the historical cost concept. We have already seen the reasons to this in chapter four.

5.2 DEVELOPING ALTERNATIVE APPROACHES - MODIFICATIONS TO
HISTORICAL COST

Accountants have made several attempts to cure some of the more obvious deficiencies of historical cost accounting. One expedient which has gained acceptance in the United States (as a result of its recognition by the American tax authorities on the basis that if it is applied for the purposes it must be used in the accounts) is the LIFO basis of determination of inventory costs. By matching the most recently incurred inventory costs against revenues in the income statement it adjusts for price rises (or falls) between the date inventory is acquired and the date it is sold. It thus achieves a closer matching of current costs against revenues in the income statement, but it does this at the expense of showing during a period of inflation, a balance sheet valuation of inventory which becomes progressively more and more out of date.

FIFO, on the other hand, produces a balance sheet valuation of inventory which is current, but results in the matching of out-of-date inventory costs against revenues in the income statement.

Another expedient, intended to deal with the problem of fixed assets and depreciation provisions, is to revalue the fixed assets periodically. This practice is not acceptable in the United States, and it is uncommon in Canada. It is employed by some companies in Britain, and it is very popular in Australia

and New Zealand because the tax laws permitted tax free stock dividends to be paid out of revaluation surplus. This procedure is not altogether acceptable to management since, although depreciation must be provided on written up values, any excess over historical cost depreciation is not normally permitted as a deduction for tax purposes.

Another proposal which has been put forward is described as 'Price-Level Accounting'.⁶ This entails the restatement of all the figures in the balance sheet and income statement in terms of measuring units of equal purchasing power. A time series of an appropriate general price index, published by the government, is used as the basis for a restatement of all unexpired costs (assets), liabilities, and residual equities in the balance sheet and all costs and revenues in the income statement, in terms not of the "historical" figures attached thereto but expressed as their equivalent in current purchasing power measured in terms of the current general price level. The general price level is the weighted average of the prices of goods and services within the economy and is measured by an index with a base year assigned a value of 100. The reciprocal of the general price-level index represents the purchasing power of the pound, the dollar, or any other monetary unit. Thus, if year 1 = 100 and year 5 = 125, the current purchasing power of the monetary unit amounts to only 80% ($100 \div 125$) of the base-year pound or dollar, etc.; in other words prices have risen 25% and purchasing power has decreased

by 20%. The most common measures of the general price level are: Consumer Price Index, Wholesale Price Index, Index of Retail prices, and Gross National Product Implicit Price Deflator.

This method does overcome the statistical objection in that all monetary equivalents are on the same scale, and moreover, they are current to the end of the period rather than some earlier point in history. Statistically, therefore, it would be possible to compare the results and capital of different companies.

General Price-Level Adjustments are not enough: The figures in price-level adjusted accounts can differ materially from those in conventional accounts, even when price levels are not rising very rapidly. The price-level adjusted figures for income and retained profits will usually be lower than the conventional figures, and this is chiefly attributable to losses on holding net monetary assets, and increased figures for depreciation and cost of goods sold. Very little adjustment is required in revenue figures since, except in rare cases, these are generally expressed in current terms.

The historical cost basis of accounting results in the matching of historical costs against current revenues. Price-level accounting, by adjusting for changes in general purchasing power, results in the matching of historical costs, adjusted for

changes in purchasing power since they were incurred, against current revenues. It also reflects losses arising through holding monetary assets through inflation of the general price level.

However, it must be recognised that price-level accounting in no way abandons the realization principle. All the methods and procedures traditionally associated with historical cost accounting are preserved in price-level accounting, the only difference is that the "values" are all measured in units of equal purchasing power. Price-level accounting involves us in a translation from a maintenance of money capital intact concept to a maintenance of general purchasing power intact concept of income determination. Like the historical cost basis it is still a "venture concept" and in the final analysis it is based upon a presumption that preservation of the general purchasing power of the invested capital is the objective (presumably in order that on ultimate liquidation this can be invested outside the enterprise in general consumer goods equivalent to those whose consumption had to be sacrificed in order to make the original investment in the company). This is not a "long-run going concern" approach. Those who support the general concept of current cost for profit determination either consciously or subconsciously do not subscribe to the going concern convention.⁷ They want to see the shareholders' interests protected in such a way that if the company ever went into liquidation, the shareholder would receive at least the same number of purchasing-power units as those he put into the company in the first place.

But the company is not going into liquidation. It hopes to survive, expand and prosper. The shareholder is not going to be paid back his monies. The shareholders' interests are in the stock exchange where share prices will reflect management's efforts to make the company prosper and survive. This can only be done by ensuring that the physical assets of the company are protected at all times, and that in addition, satisfactory profits are earned.

"A company usually has certain limited objects, and the maintenance of its capital should be considered in relation to those objects. If adjustments are made by reference to a general index, differences between changes in the (current) replacement cost of the particular classes of assets used in the business and changes in the general price-level will be registered in current income, which will no longer reflect the current costs of using the particular classes of assets owned by the company." (8)

If the concern is going to survive, accounting for the concern must be carried out in costs which are real and specific to it, and not in costs which are intended to reflect the general purchasing power of money.

A general price index, particularly a general consumers' price index, is a weighted average of the price changes occurring in a very wide variety of goods and services available within the economic system. Only by coincidence will a change in the general price index correspond to a change in a price, over the same period of time, of any given good or service. Thus, if the

general price index has increased, many specific price increases will be lower than that of the index, whilst many others will be higher, and there may well be specific price decreases. Furthermore, discrepancies between specific price changes and general price changes are likely to be even greater when the general price index is a consumer index and when the specific price change relates to producer goods such as those represented by the assets of a typical commercial or industrial enterprise.

In short, general price-level adjustments will not result in balance sheet values being expressed in terms either of current replacement cost, or current net realizable values. Also, profit, to a firm, can exist only after matching against revenues the firm's specific current costs of the assets which are used up in earning those revenues. Only by recording its own specific costs can any company know its real profits. Only in this way can a company know exactly where it is going, what real margins it is producing in the selling price it is obtaining, and what real return it is getting on its real capital. Only in this way can a company be a real benefit to its shareholders in the long term. Profit must be calculated using the going concern specific current costs of the firm in order to reveal to the shareholders its long-term profit possibilities. In other words, general price-level adjustments will not ensure that the "costs" being matched in the income statement are in any sense a representation of the current cost of obtaining the equivalent input of goods and services. To see whether this fact is of any significance

in income (profit) and value determination, let us examine what is meant by the terms "value" and "income" (profit).

5.3 VALUE AND PROFIT

5.3.1 The Interrelationship of Value and Profit

Value and Profit are capable of a variety of interpretations, the terms used in economics carry substantially different implications from the same terms in the context of conventional accounting, and worse still the meanings within each area are far from uniform.

In broad terms the economic approach has been one of developing concepts to explain economic activity and until relatively recently economists have not been unduly burdened with applying their concepts, whereas the conventional accounting approach has generally been concerned with finding adhoc solutions to specific measurement problems with little regard to the validity or purpose of the overall result. The approach we shall adopt here will examine concepts before trading down to bases which are measurable with some degree of 'objectivity'.

A useful starting point is a definition of profit, by the economist Marshall, which is wide enough to provide a meeting point for the major concepts of profit in both economics and accounting:

"When a man is engaged in business his profits for the year are the excess of his receipts from his business during the year over his outlay for the business. The difference between the value of his stock of plant, materials, at the end and at the beginning of the year is taken as part of his receipts or as part of his outlay according as there has been an increase or decrease in value." (9)

It is evident that profit is not simply the increase in cash made available from business activities but includes some value (positive or negative) arising from the change in resources commanded during the period; moreover the implicit assumption that cash and value are additive begs the question of whether the value of cash can be considered constant. Thus profit (income) and value are interrelated concepts and a consideration of value will have implications for the subsequent discussion of profit.

5.3.2 The Meaning of Value

The theory of value was of major concern to classical economists. Although ideas in this area have had negligible influence on conventional accounting, they provide useful insights into the meanings which can be attached to value and indirectly into the implications of valuation for business purposes.

Throughout the economic discussions of the eighteenth and nineteenth centuries there was difficulty over the exchange value of goods (the prices at which goods are bought and sold) and their value in use (utility, in terms of the total satisfaction

the possession of the goods conferred). There seemed little correlation between these two attributes, as Adam Smith observed in a famous passage:

"Nothing is more useful than water, but it will purchase scarce anything: scarce anything can be had in exchange for it. A diamond, on the contrary, has scarce any value in use, but a very great quantity of other goods may frequently be had in exchange for it." (10)

This seeming 'paradox of value' arose because economists at that time confused value in use (= total utility) with marginal utility. Total utility refers to the total satisfaction obtained by an individual purchaser from the total stock of a good held (or consumed) at a particular time; the concept of marginal utility refers to the satisfaction obtained by an individual purchaser from the last unit acquired. An individual purchaser would become more rapidly satisfied with additional units of water than he (or she) would with additional diamonds; consequently the marginal utility of water can be considered to decline more rapidly than that of diamonds. In choosing between water and diamonds the individual will exchange so long as the increase in satisfaction from acquiring one good exceeds the sacrifice in satisfaction from foregoing the other.

But utility concerns only one side of the determination of exchange value, the demand side. In temperate climates

units of water can be obtained at relatively small sacrifice (if only by collecting rain water); thus the cost of production is low and supply can be said to be plentiful. Conversely the discovery of diamonds involves considerable search effort and supply is scarce. However, the cost of producing either good is unlikely to remain constant for all units; acquiring additional units per time period will require, say, storage facilities for water or considerable more search effort and mining equipment for diamonds; additional units would therefore be more costly to produce than earlier units so that marginal cost of production would be rising, if less rapidly for water (plentiful) than for diamonds (scarce).

It was Marshall who brought the synthesis of utility and cost of production, showing the fundamental symmetry of the general relations of supply and demand to exchange value by way of an analogy with the blades of a pair of scissors:

"We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether (exchange) value is governed by utility or cost of production. It is true that when one blade is held still, and the cutting is effected by moving the other, we may say with careless brevity that the cutting is done by the second.

.....as a general rule the shorter the period we are considering, the greater must be the share of our attention which is given to the influence of demand on value; (because supply can be considered as virtually fixed in the very short period) and the longer the period, the more important will be the.....

....influence of cost of production on value (because in the long run production can be adjusted to some specific level of demand)." (11)

In this way Marshall showed that exchange value is jointly governed by marginal utility, and marginal cost of production.

A consumer can be said to maximize his (total) satisfaction by equalizing the marginal utility per £ spent on each and every good; in other words by equating the ratios of the marginal utilities of the goods he purchases to the ratio of their prices and to the marginal rate of substitution between them. This does not imply that utility, in the sense of satisfaction obtained, is measurable in money terms, nor is there any implication of equality of marginal utilities between different individuals.

It is only the price of the last unit exchanged by the individual which is equated at the margin but all units held can be assumed interchangeable, so that provided marginal utility declines with the acquisition of additional units the individual would have been prepared to pay rather more for earlier units than go without the good altogether. This difference between the exchange price of acquisition and the notional price which individuals might have been prepared to pay is termed 'consumer surplus'.

From the above discussion it is evident that the multiplication of exchange value (current price per unit) by the number of units of a good held or acquired does not represent value either in the sense of total utility to the individual or in the sense of the maximum price which the individual would be prepared to pay. It does represent value in the limited sense of the price which could be obtained for the goods or price at which the goods could be replaced provided such action would not affect the exchange value (e.g. cause glut or scarcity in the market) and there were no costs in undertaking transactions.

What relevance does all this have for the business firm? The firm's demand for goods is a derived demand, in the sense that the firm is concerned with purchasing goods which are sold eventually (commonly in different physical form) to consumers. The firm's proximate concern is therefore with the exchange value of its inputs in relation to the exchange value of its outputs, but any expectations of exchange values imply assumptions about the relationship of market demand for the product and its supply and about the supply/demand relationship for inputs.

The commonest (although not always stated) assumption in discussing the exchange value of a firm's assets is that the firm's own demand for inputs and its supply of output are both insignificant in relation to the total transactions of the market as a whole. Thus the firm's actions could not affect market price

(which, as we know, is determined at the margin), and exchange value per unit multiplied by the number of units held would provide a valid exchange value for assets held by the firm. Although this is a very convenient assumption which will be adopted for our purposes, it is only a useful rule of thumb: consider what would happen to the market price of diamonds if the considerable diamond inventories of de Beers Consolidated (the diamond producer) were offered for sale at one time in the market. Current market price per unit provides the exchange value of assets only if asset transactions by the firm would not affect market price.

Let us now consider three major questions affecting valuation which were implicit in the above discussion: what fate is intended for the object being valued?; from whose viewpoint is value being considered?; how is value to be measured? Each question will be examined in turn.

5.3.3 Value for What?

If an object is not held for its own sake but for the receipts it will bring, as business assets are, the object's eventual fate can be assumed to be exchange for cash. When assets are held for use the benefits from the asset can be assumed to be incorporated in the firm's output - which is sold for cash. Timing is important: the firm can dispose of the asset now or at some point in a continuum of future dates. More-

over the firm may face several opportunities for disposal/employment at any one time. For the present purposes it will be assumed that the firm has selected the 'best' fate for its assets.

Since assets are held for exchange (in one form or another), exchange values are patently relevant for business assets. Three possible views of exchange values¹² are:

Past: the price ruling in the market when the asset was acquired;

Current: the price at which the asset could be acquired or disposed of currently;

Future: the cash (net receipts) which the asset is expected to yield through employment/production and/or eventual sale.

Note that any value must relate to a specific place and time, these values will be viewed in relation to their relevance for 'here and now'.

(a) Past Exchange Value: Under past-purchase-price valuation, more commonly called historical-cost valuation, the market price used in asset valuation is the acquisition cost of an asset at the time of purchase (including costs to put in working conditions) manufacture, or construction. It is the total of the exchange

prices, or price aggregates, to obtain an asset and render it suitable for its intended use. Thus, historical cost is measured by the cash or cash equivalent sacrificed in exchange for obtaining an asset. This need not necessarily coincide with the exchange value ruling in the market at acquisition - a particularly favourable or unfavourable bargain could have been made - but exchange value will be assumed here.

As we have already seen in chapter four, in current accounting practice, historical cost is the normal valuation method used for non-monetary assets (inventory, property, plant and equipment). The historic cost of an asset need not approximate to any price at which this (or similar) asset can be bought or sold currently or in the future.

(b) Current Exchange Value: We must acknowledge the fact that there are almost invariably two exchange values for any asset. Business firms engage in economic activities in two different markets, a situation that results in two basically different exchange prices. One is exit (output) exchange prices, representing the assets to be received by the firm from the sale of its output (goods and services) - selling prices. The other is entry (input) exchange prices, representing the assets to be sacrificed to obtain other assets (inputs) to be used in operations - purchase prices. Even in a highly competitive market there is some transaction cost of bringing buyers and

sellers into contact with each other, when exchanges of a particular good are rare, or goods are not homogeneous, dealers may require very wide margins to recompense them for the time which elapses before a buyer can be matched with a seller and for the risk that the price may have to be reduced to avoid holding some goods indefinitely.

Since the objective of a firm is to sell goods for a price greater than that at which the goods were acquired, a firm will have a normal expectation of selling the goods in which it deals at an exit price above entry price. Conversely almost every firm holds some goods, usually fixed assets, for employment as agents of production in the firm rather than for sale; as the firm would not have the advantage of dealing in such goods the normal expectation would be that such goods could only be sold in their present condition at an exit price below the entry price. For example, a garage which currently buys a motor van for £ 600 (entry price) may consider the current exit price to be £ 800; a bookseller who buys the van for £ 800 (his entry price) would have considerable difficulty in selling the van brand new for anything approaching £ 800. A decision as to which exchange value is relevant to the owner of an asset clearly hinges upon expectations regarding the fate of the asset.

Historic cost considered earlier was in fact an entry price, corresponding to which there would have been some hypothetical exit price at the time of acquisition; such a past hypothetical

price has no current significance.

In accounting, entry price is usually termed replacement cost and exit price (net after any costs involved in selling) is termed net realizable value. These terms used without qualification mean current exchange values.

(1) Current Purchase Prices (Replacement Cost): Under current-purchase-price-cost-valuation, more commonly called replacement-cost valuation, the market price used in asset valuation is the market exchange price to acquire existing assets held by the firm (replacement in kind). For merchandise inventory, raw materials, and purchased parts, replacement cost is the current quoted purchase price based on normal quantities obtained from normal suppliers at the financial-statements preparation date. For goods-in-process and finished-goods inventories of manufacturing firms, replacement cost is the current cost to manufacture such inventories based on the current purchase prices of raw materials, labour, and factory overhead at the financial-statement preparation date. Where no current purchase prices are available for particular assets held by the firm, then replacement-cost valuation would be approximated by the use of specific price indexes for similar assets or by appraisals.

As to liability valuation under replacement-cost valuation, short-term liabilities would be reported in the balance sheet at face amount (amount owing), because the gains or losses to adjust

then to current-purchase-price valuation are usually too small to warrant such adjustments. On the other hand, long-term liabilities would be reported at current purchase prices (current market purchase prices plus commissions), in order to show how much was saved (or additional cost) by borrowing at terms more favourable (or less favourable) than those that currently exist.

With regard to income determination under replacement-cost valuation, net income is reported in the income statement so as to show both holding gains and losses (holding assets and liabilities while their purchase prices rise or fall) and operating profit (profit from actual sales of goods and services). As suggested by the leading proponents of replacement-cost valuation, Professor Edwards and Bell,¹³ two net-income figures would be reported. One net-income figure, which they call "realized profit", would be based only on realized holding gains and losses (realized by sale or use). The other net-income figure, which they called "business profit", would be based on both current period realized and unrealized (not realized by sale or use) holding gains and losses.

(11) Current Selling Prices (Net Realizable Value): Under this approach to asset valuation, as advocated by its leading proponent, Professor Chambers, assets are reported at their present realizable sales prices at the balance-sheet date.¹⁴ Such selling prices are quoted market selling prices of assets

of a similar kind under conditions of orderly sale. They are not liquidating selling prices under conditions of forced sale. Moreover, the use of selling prices does not assume that assets on hand will necessarily be sold at those prices, but that current quoted market selling prices are used as indicators of present cash equivalents.

As to liability valuation, Professor Chambers argues that liabilities should be reported in the balance sheet at their face amount - the amount owing. In other words, selling-price valuation is used only for asset valuation, whereas liability valuation is based on the amounts owing. The argument is that the debtor company owes the contractual amount regardless of the price at which the debt instruments (such as bonds) are being, or could be, sold in the market. A related argument is that to use the market selling prices of outstanding equities is tantamount to the valuation of the business as a whole, which is not the purpose of the balance sheet.¹⁵ That is, the purpose of the balance sheet is to show current financial position by reporting assets at current selling prices, liabilities at face amount to show the claims against the assets, and stockholders' equity at the residual interest in the assets.

The income statement under selling-price valuation reports the net assets (assets minus liabilities) at the end of the fiscal period, after adjustments for any capital changes and dividends, from which the net assets at the beginning of the period

are subtracted to derive net income or loss. Thus, net income is viewed as the result of the valuation of a firm's net assets. The emphasis is on asset valuation, since it is the assets that generate a firm's income, and the change in the valuation of net assets (after adjustments for capital changes) is net income.

(iii) Future Exchange Value: A firm acquires assets with the intention of disposing of them in future time periods, either in their original form or in a transformed character through employment within the firm. The future exchange values are of fundamental importance to the firm, but in order to provide a currently meaningful value (e.g. for comparison with prices for disposing/acquiring assets currently) three major aspects must be considered in the determination of a single value based on future expectations.

Firstly, financial-statement preparation based on future exchange prices necessitates predicting a company's future cash receipts (from expected future sales and the rendering of expected future services) and future cash disbursements (expected future acquisitions of factors of production needed to generate cash receipts). Expected future cash receipts and disbursements are based on estimates of future selling prices and acquisition prices, as well as estimates of future quantities.

Secondly, in order to prepare financial statements based on future cash flows, it is necessary to convert the future cash

flows into equivalent pounds today by discounting them to obtain present amount (value). The use of expected cash flows in the valuation process means that there is a time lag (or waiting period) before the actual cash flows occur; hence future pounds are converted into equivalent present-day pounds by computing the discounted amount (present value) of the future pounds.

Thirdly, asset holding, which can be interpreted as any commitment of current resources in the expectation of future benefits, involves risk and uncertainty in the sense that expectations of future exchanges of value (future cash flows) may not be achieved.

Most expectations relate to a range of possible outcomes rather than a point estimate of a particular outcome, even though it is very common to specify expectations naively in terms of 'most likely' amounts. The range of possible outcomes and the level of confidence which can be attached to particular outcomes within this range can be considered as determining the 'riskiness' of expectations; the wider the range of possible outcomes and the lower the level of confidence which can be attached to particular outcomes within the range the more 'risky' is the asset concerned. As a first approximation it can be assumed that a firm will prefer to receive say £ 100 with near certainty to some 'most likely' but 'risky' expectation of the same amount; consequently some adjustment for riskiness is implicit in translating future expectations into a present value. This adjustment may take the

form of scaling down future amounts or scaling up the interest rate employed in translating amounts to the present time.

Under discounted cash-flow valuation, assets would be reported on the balance sheet at the discounted amount of the expected future cash receipts. Liabilities would be reported at the discounted amount of the expected future cash disbursements. Owners' equity would be reported at the discounted amount of the expected future net cash receipts, which is equal to the difference between the discounted amounts of the assets and liabilities.

Net income under discounted cash-flow valuation is equal to the discounted amount of owners' equity at the beginning of the period, multiplied by the interest rate used in discounting the future cash flows, assuming that the predictions of the estimated future cash flows are correct. This is why income is called subjective income, since it is based on the subjective valuation of the firm's net assets at the beginning period, multiplied by the discount rate.¹⁶ It is also called economic income (in the Hicksian sense), because it is the amount that could be paid out to the owners without contracting the business.¹⁷ In other words, by withdrawing cash equal to the net income, the business is as "well off" at the end of the period as it was at the beginning since the discounted amount of owners' equity remains the same (assuming owners' equity is adjusted for any capital changes).

5.3.4 Value to Whom?

On the question of value in relation to the firm there are two major viewpoints which might be adopted. One is that of shareholders, which is concerned with issued shares representing ownership claims against the company. The other viewpoint is that of 'the firm' as an entity, which is a quasi-managerial view concerned with resources controlled by the firm and claims against the firm.

Value concepts which might be candidates for consideration from each viewpoint are illustrated in Table 5.1. It is assumed that the shares can be readily bought or sold on a stockmarket.

Value viewpoints have been compressed in Table 5.1. The continuum of future exchange values has been eliminated by an assumption that the most favourable opportunities are adopted to give present value. The present values of future entry prices have been ignored.

(a) Shareholder Viewpoint: It might appear that a company which operates for the benefit of its shareholders should adopt a currently quoted share price (entry or exit) as the benchmark concept of value, possibly in the context of recording the accounting value of the firm in terms of share price. Such a view is an over-simplification; certainly the multiplication of the number of issued shares by the current market price gives a

Table 5.1: MAJOR VALUE VIEWPOINTS IN RELATION TO A FIRM

Value to whom?	Exchange Value Bases			
		Past	Current	Future
Shareholder viewpoint (shares held in company)	Entry	Historic cost to shareholder	Entry price at which a shareholder can buy.	
	Exit		Exit price at which a shareholder can sell	Present value of future dividends and eventual disposal of shares
Firm viewpoint (net assets of company)	Entry	Historic cost to company	Replacement cost	
	Exit		Net Realizable value	Present value of future cash flows

(a) Shareholder Viewpoint: It might appear that a company which operates for the benefit of its shareholders should adopt a currently quoted share price (entry or exit) as the benchmark concept of value, possibly to the extent of recording the accounting value of the firm in terms of share price. Such a view is an over simplification; certainly the multiplication of the number of issued shares by the current market price gives a

value which has an attractive objectivity as a measure of value for many purposes, but it is neither the unambiguous measure of value to shareholders which it seems nor does it necessarily serve accounting and management purposes.

An individual shareholder can be assumed to have some assessment of present value of his shares based on his own expectations. The rational shareholder would sell his shares when exit price exceeds his present value and buy more shares when entry price falls below present value; since the margin between entry and exit prices of widely traded shares is normally small it would appear that current market price should approximate to the estimation of present value by all shareholders. Unfortunately complications of tax liabilities on sale of shares, investors' funds constraints and the inertia of shareholders make such a generalisation suspect. Market prices are determined by dealing at the margin (by shareholders who find it worthwhile to deal) and it is observable that a substantial surplus over current exchange price is usually necessary to induce the majority of shareholders to sell their shares, e.g. in a take-over bid. Consequently share prices are only rough, although undoubtedly the most objective indicators of value to shareholders.

Most important for accounting, share prices are themselves partially determined by accounting information. The adoption of share prices for assigning value to a firm in its own accounts would be both circuitous and uninformative; data on prices of

quoted shares are already easily accessible. Finally a shareholder viewpoint could not be employed where shares were unquoted.

(b) Firm Viewpoint: The firm viewpoint is based on the total assets owned by the firm less the liabilities to non-owners which it must meet; these net assets represent the ownership resources which the firm controls as agent of the shareholders. The firm viewpoint can be considered (at least conceptually) as singular, in contrast to the multiplicity of views on value which might be held by shareholders.

The central concept of value from the firm viewpoint is the present value of the future cash flows arising from assets and liabilities of the firm. Future transactions between the firm and its shareholders are excluded because the firm's value belongs to the shareholders as a whole; for example, future dividends will reduce the ownership rights of shareholders but they can be assumed to provide a corresponding increment to shareholders' personal wealth (tax makes this a cavalier assumption, but the point is that the strictly firm viewpoint does not enquire into individual circumstances and preferences of shareholders). If the firm's management operates solely in the interests of shareholders as a whole it will seek to maximize its subjective estimate of present value of the firm. If the expectations prove correct the benefits will eventually accrue to individual shareholders through dividends and the adjustment of market prices of shares, in other words management would not be indifferent to

share price but management expectations may be several steps ahead of, or at least different from, the criteria determining current share price. In the maximising firm any decision on the acquisition or disposal of resources implies a comparison of current exchange value with the present value of these resources to the firm, and all resources retained by the firm should have a present value greater than (or at least equal to) the exchange value currently available to the firm.

The preceding paragraph requires some qualification. Firms do not necessarily formulate their decisions explicitly in terms of present value and in any case the inter-dependencies of resources within the firm may often make explicit formulation exceedingly difficult; but the present value concept is not invalidated. More important, the decisions of firms are not invariably undertaken in the interests of the owners; in some respects a concept of utility to the firm as an organisation or to management as an entity may be appropriate. For example, the commissioning of works of art to decorate a company's head office may make more sense in terms of utility than in terms of present value, but it is difficult to be sure; such decisions can be, and often are, rationalised in terms of present value - say benefits from better working environment or even expected price rises for the works of art. Finally, firms may seek some 'satisfactory' performance rather than maximisation; even so a satisfactory margin between present value and currently available exchange value is implied, if not the best available margin which might be obtained by an exhaustive search for opportunities.

5.3.5 How Might Value be Measured for Entity Accounts?

The discussion of value concepts has supported present value as the fundamental concept of value to the firm. With regard to decision making the relevance of present value (explicitly or implicitly) is inescapable, but our immediate goal is value measurement for entity accounts. How might value be measured for entity accounts? To answer this question we must turn again to the discipline of economics and see what is the economic concept of value. From our discussion of value theory presented above, we can see that assets have value because they are scarce and are capable of rendering future services to their owners. Since most items are scarce, the important measurement is the value of the services which the item will yield. Therefore, the monetary value of an asset's future services must be determined in order to calculate its value. This should be done at the end of each accounting period, in order to properly determine financial position. Simply stated, the value of an asset in economic theory is the discounted value of its future income stream.

A number of well-known economists - including Eugene V. Bohm-Bawerk, Irving Fisher, John B. Ganning, John Maynard Keynes, and J.R. Hicks - laid the theoretical foundations for measuring asset values via the expectations concept in which values are dependent entirely upon the net future receipts to be derived from their use.¹⁸ Using the term

capital in the sense of resources or assets, Professor Fisher wrote:

The value of any property, or rights to wealth, is its value as a source of income and is found by discounting that expected income.....The value of capital must be computed from the value of its estimated future net income, not vice versa..... 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 capital is derived from the value of income." (19)

John B. Canning, in his 1929 work, has stated:

"Beyond doubt, the accountant would like to mean by 'financial position' a position declared by direct positive measures of funds to be provided by enterprise operations." (20)

This would mean that asset values would be expressed as the capitalized earning power they possess, that is, in terms of discounted future fund flows.

There appears to be wide agreement that, conceptually, the soundest measure of an asset's value is the discounted value of the future cash flows that it will generate. This valuation concept was considered a useful abstraction by the committee on Accounting Concepts and Standards of the American Accounting Association in its 1957 statement, as indicated by the following:

"The value of an asset is the money-equivalent of its service potentials. Conceptually, this is the sum of the future market prices of all streams of service to be derived, discounted by probability and interest factors to their present worths." (21)

Sprouse and Moonitz also recognised the discount factor in Accounting Research Study No. 3. In their discussion of the measurement of assets, they state:

"As a general rule, the valuation of these assets (money or claims to money) should be based on the amount of cash into which they will be converted, that is, their discounted future exchange prices." (22)

Let us now look at the advantages of the above Net Present Value Model, if it is used for value measurement for entity accounts:

(1) Assets are future economic benefits, and liabilities are future obligations. Companies acquire assets because the discounted amounts of their future economic benefits are expected to be greater than or equal to their current purchase prices. Companies incur liabilities today because it is expected that the resulting assets received will provide future economic benefits that are greater than or equal to the discounted amount of the economic obligations of the liabilities. Since assets are acquired and held and liabilities are incurred because of expectations of future economic benefits, it is conceptually sound

that the valuation of such assets and liabilities be based directly on the discounted amount of future economic benefits - discounted cash-flow valuation. In other words, discounted cash-flow valuation is useful as a normative (should-be) model of valuation, since it is based on direct valuation.

(ii) Accounting, as an information provider, must present figures upon which rational decision-making can be made. The following decisions are pertinent to accounting data,²³ as already mentioned earlier:

- (a) Decisions of shareholders
 - in their appraisal of management
 - in respect of their shareholdings
- (b) Decisions of potential investors
- (c) Decisions of management in their function of manipulation of scarce resources to maximize business goals and of obtaining optimum resource allocation and combination
- (d) Decisions of creditors, governments and employees in their relationships with the entity.

Only the N.P.V. model meets the requirements of relevance for decision making. Only by reference to the worth of the firm in the continuous activity can shareholders appraise management or make decisions to buy and sell their shares. Only by

reference to discounted cash flow values can creditors recognise security and can governments make decisions of economic policy affecting business. Management, too, must know the expected returns and effects of past decisions in order to formulate new decisions, especially those concerning alternatives.

In short, current financial decisions cannot be meaningful without some expectations of the future. Therefore, to aid investors, creditors, and other statement users in their financial decision-making, it can be contended that financial statements should be based on expected future exchange prices-discounted cash-flow valuation.

The question before us, now, is, can we therefore use the N.P.V. model for measuring value for entity accounts?

The Philosophical Notions of Relevance and Objectivity:

There exist, common to all disciplines, several notions which are derived from the central core of philosophical thought-logic, mathematics and metaphysics and which provide constraints upon those disciplines which themselves take on the form of positive fields of knowledge developed by reference to a restricted environment. These notions do not form part of a theoretical structure of a field of knowledge (although they can be utilised in the formation of the structure) but rather act as constraints upon the application of the theory. Two²⁴ such notions are:

- (i) relevance
- (ii) objectivity

Let us say it again that the above N.P.V. model or structure of asset valuation theory is complete in logical necessity within itself and thus acceptable for application to the accounting situation. However, how does it bear up when subject to these constraints?

(i) Relevance: We have already seen above that this model meets the requirements of relevance for decision making.

(ii) Objectivity: Let us apply to this model the second constraint of objectivity.

If the value of an asset to a particular enterprise is the discounted net present value of all future cash inflows derived from that asset, it follows that its measurement is obtained by discovering those future cash flows and discounting them back at the prescribed rate of interest to the present date, as we have already seen above. This is the conceptual ideal. If men were omniscient (in which case there would be no need for accountants), they could see the actual cash streams flowing from each asset and the problem would end here. However, this is not the case and so the following difficulties remain:

(a) The estimation of the total future revenue and cost streams for the whole firm with the existence of uncertainty. The measurements are subjective estimates of the outcome of future events. The essence of the problem of business activity is its risky, uncertain nature. Facing the same circumstances, different people assess the situation differently. Attitudes towards risk differ. Different weights are attached to the importance of time, so that future events are discounted at different rates. Personal scales of values differ, e.g. as between the rich and the poor. This suggests that it would probably be both helpful and realistic to show profit and wealth only as being probably within a stated range.

An assessment of net worth measurements, e.g. by an auditor, require the assessor to compare his own attitudes with those of the owner. Is it then necessary to introduce the concept of a 'rational man' into the comparison? What would be his attitudes and standards? The managers of a company may delude themselves by using inappropriate standards for their own reports, one manager may deliberately inflate or deflate prospects to another. These are matters of internal control, which arise whether or not present value calculations are made. The auditor who assesses reports presented to members by directors must ensure that there is adequate evidence on which to base the measures, that a clear and full statement is made of the assumptions on which the estimates are based, and that the necessary arithmetical procedures have been properly applied.

(b) The second, and related, problem of net worth measurement is to decide how far into the future to make estimates. If the firm (or asset or liability, as the case may be) must be liquidated by a known certain latest date, the longest period over which estimates should be made in respect of that firm, etc. is known. A shorter period may be more appropriate. If there is no final terminal date, it is apparently possible to make estimates to infinity. But using a discount rate of 12 per cent p.a., the present value of £ 1,000 received 10 years hence is £ 322; the present value of £ 1,000 received 20 years hence is only £ 104, and the present value of £ 1,000 received 50 years hence is a mere £3. Infinity seems to be unnecessary. Can a time limit, or horizon, be suggested?.

(c) The third significant problem of making net worth measurements is to determine the rate at which to discount the cash flows, i.e. the problem of determining the cost of capital to the firm.

(d) A fourth problem encountered in making measurements of net worth is the difficulty which is likely to be experienced in attributing receipts and payments to specific assets in order to establish values for them. The more specific and complementary the assets are, the greater the difficulty becomes. It is particularly apparent in the case of fixed assets; it is of course, encountered also in any systematic attempt to appraise capital expenditure proposals, whether by discounted cash flow or other

techniques. It is another facet of the problem of 'jointness'. Cash flows are derived, not from specific assets, but rather from combination of assets. For example, no cash flows can be generated from a machine until it has a building around it. Similarly, one part missing from the production line can reduce the total cash flow from the production line to zero, but is it correct to attribute all of the cash flows from the process to that part? If so, which one of the many parts? This has been called the "homogeneity problem".

(e) Another problem is that the discounted value of the differential cash flows of all of the separate assets of the firm cannot be added together to obtain the value of the firm. A difference is certain to arise between the sum of the asset valuations and a separate appraisal of the present value of the firm as a whole. Indeed, there is likely to be a difference even if an acceptable present value can be calculated for every asset. It is similar to the measure of "goodwill", or "cost of control", which commonly arises on the consolidation of the accounts of a group of companies. It represents either:

- (i) Inconsistencies in the valuation of some or all of the assets, both interse and with the overall valuation of the firm, or
- (ii) A measure of the assets and liabilities, probably of an 'intangible' nature, which have

not been valued, e.g. the management team, good labour relations, attractive and rewarding brand images, or some advantage arising from imperfections in the structure of the markets in which the firm operates, such as price or trade agreements, monopoly, or monopsony.

(f) Lastly, but not the least, in the real world of uncertainty, where a firm's actual cash flows would be found after the fact to be different from estimated cash flows, it is highly questionable how to report such deviations. But more important, there is the question of whether the reporting of historical deviations between actual and estimated cash flows would provide useful information for financial decision-making purposes. In other words, there would be a mixing of historical deviations and discounted amounts based on future cash flows in the financial statements that would be confusing to statement users.

The above constraint of objectivity and the related problems discussed above demand that we find a practical approximation of N.P.V. for these assets. In other words, it is necessary to compromise conceptual soundness in order to devise practicable methods for the measurement of asset values. One of the major

functions of entity accounts is to aid in the assessment of earlier decisions, and a series of unverifiable subjective present values would be useless for this purpose. It is thus necessary at this stage to trade down to value concepts which are capable of measurement with some degree of objectivity.

What is Objective? Rather than entering into a philosophical discussion, let us accept one of the meanings given in the Concise Oxford Dictionary as 'exhibiting actual facts uncoloured by the exhibitor's feelings or opinions'. In an accounting context a concept capable of objective measurement would be one which gave sufficient guidance to enable two or more accountants acting independently to arrive consistently at the same figures. It can be said at once that only a record of past cash transactions would ensure such objectivity in accounts, to the exclusion of information on other resources of the firm and on the profitability of those resources; the best value concept which can be hoped for is one which constrains the influence of personal opinion and yet provides information which serves the purposes of users.

With present value eliminated the candidates are historic cost and current exchange values. Determining historic cost is merely a matter of documentation and recording an acquisition; thus historic cost is undoubtedly objective. Relevance is another matter. It must be admitted that a defender of conventional accounting and historic cost would say that accounts do not

purport to indicate values in any sense, but instead represent an historical record of past transactions. This view would be credible if accounts were simply chronological records of cash transactions at historic cost, but conventional and entity accounts provide history without dates and yet are riddled with estimated amendments to the historical record. The conventional estimation procedures for depreciation and the rules for amending current assets to 'market value' lend substantial support to the view that unadorned historic cost is irrelevant to the user.

Inevitably the argument now leads to the adoption of current exchange values. These values have two important characteristics which make them useful measures:

(a) Objectivity: Exchanges taking place in a competitive market represent a consensus of view of 'society' of value in money terms. Imitations of such prices determined 'at the margin' have already been examined, but the prices at which exchanges are taking place at a particular time are observable without being 'coloured by feelings or opinion'.

Even when prices cannot be observed in a competitive market, if the firm is currently exchanging assets of a particular character the price is prima facie the value at which it could deal with the remainder of its assets of the same class.

Considerable problems arise when neither a readily available competitive market price exists nor is the firm engaging currently in exchanges of comparable assets, for example fixed assets of the firm like plant and machinery. In such cases, estimation becomes necessary in the sense that indices for replacement cost of specific classes of assets can be used as a basis for estimation. It need hardly be said that the resulting replacement costs are approximate, but they have the advantage of being relatively easy to obtain. For fixed assets held for long periods the divergencies between historic costs and replacement costs can become so substantial that any honest attempt at updating can hardly fail to be more informative than historic costs.

As an example, an index might be prepared for changes in the purchase price of (new) heavy industrial vehicles. If the selected representatives were vehicle type A which rose in price from £ 5,000 to £ 5,500 in the period under consideration and vehicle type B which remained at £ 5,000, the index would be expressed as 100 at the beginning of the period and 105 end-period. The index could then be used to approximate the replacement cost of similar vehicles need by the firm. In fact the average would usually be weighted to reflect relative purchases in the asset class.

Estimated replacement cost would be obtained as follows:

$$\frac{\text{Current Index}}{\text{Index at acquisition of asset}} \times \left[\begin{array}{l} \text{Historic Cost} \\ \text{(less depreciation} \\ \text{for depletion of} \\ \text{asset life)} \end{array} \right] = \text{Estimated Replacement Cost}$$

Price indices for many classes of assets like broad classes of equipment, buildings and land, can be obtained from outside sources. Alternatively indices can be prepared from the firm's own data.

(b) Value to Firm: Currently available exchange values have definable relationships to present value for the firm. There are six possible permutations of the relation between present value and the current entry/exit values for a firm's assets,²⁵ ignoring the chance that one or more values might precisely coincide. These possibilities are illustrated in Figure 5.2. The exchange values available to the firm for goods in their current state may offer exit above entry price (say for goods which the firm itself is a dealer/processor) or an exit below entry price (which would be common for goods which the firm employs). For either of these alternatives present value may be above, between or below the two exchange values; the relationship should however determine the fate of the asset.

<p>CURRENT EXCHANGE VALUE (EXIT ABOVE ENTRY)</p>	<p>ASSET FATE</p>	<p>PRESENT VALUE</p>	<p>ASSET FATE</p>	<p>CURRENT EXCHANGE VALUE (EXIT BELOW ENTRY)</p>
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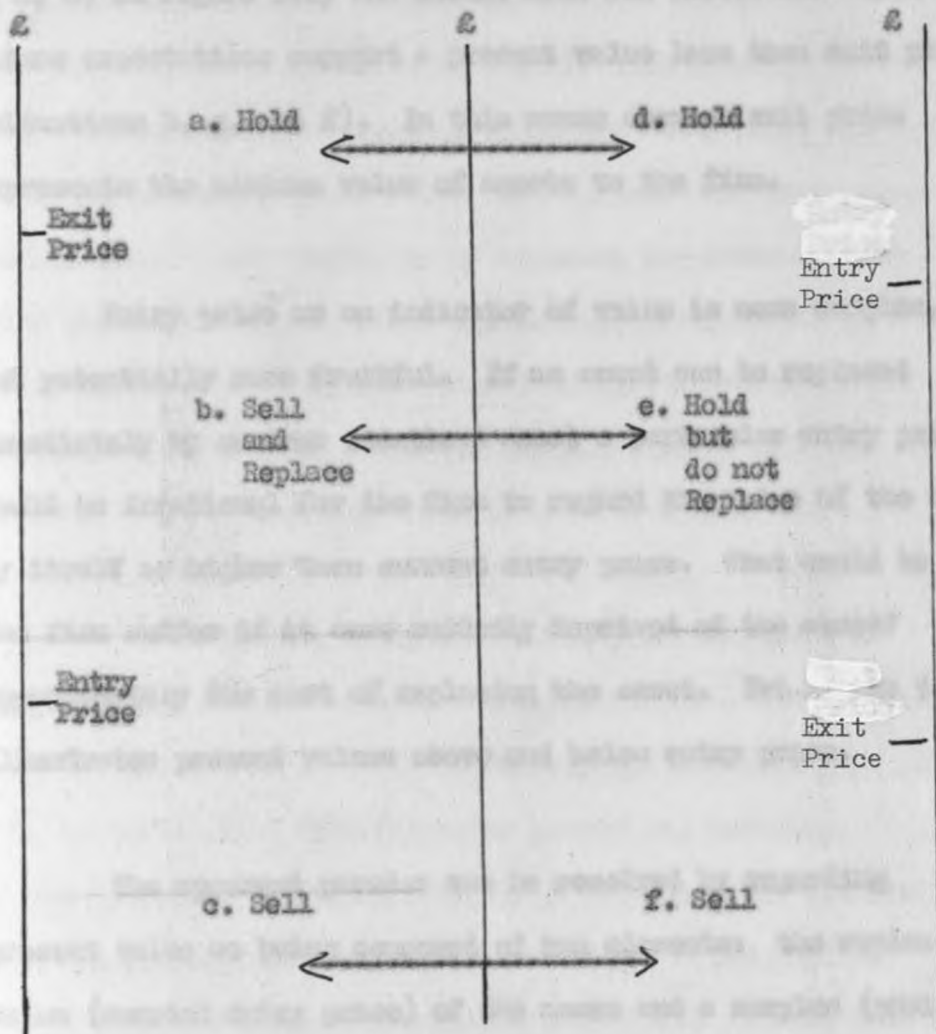


Figure 5.2: Relationship between Present Value and Current Exchange Values

The firm intent on enhancing the value of its resources should hold only those assets for which expectations support a present value greater than current exit price (situations a, d, e, in Figure 5.2) and should sell all assets for which future expectations support a present value less than exit price (situations b, c, and f). In this sense current exit price represents the minimum value of assets to the firm.

Entry price as an indicator of value is more complex, but potentially more fruitful. If an asset can be replaced immediately by another identical asset a particular entry price it would be irrational for the firm to regard the value of the asset by itself as higher than current entry price. What would be the firm suffer if it were suddenly deprived of the asset? Approximately the cost of replacing the asset. Yet Figure 5.2 illustrates present values above and below entry price.

The apparent paradox can be resolved by regarding present value as being composed of two elements: the replaceable value (current entry price) of the asset and a surplus (positive or negative) which arises from the firm's expectations of using the asset in combination with other assets of the firm. The other assets may be physical assets or nebulous assets like the 'know-how' which will enable the firm to achieve the expected benefits. The surplus of present value for the firm as a whole over the sum of the individual values of separable assets can be termed goodwill.

When present value of an asset is below entry price the situation is uncomfortable (see e. in Figure 5.2). Entry price no longer represents the amount the firm would suffer if it were deprived of the (uninsured) asset - because the asset is not currently worth replacing. The problem can be evaded in one of three ways: by adopting entry price even though it exceeds present value; by adopting exit price when this is below entry price, or by adopting the present value below entry price. The first treats negative goodwill in a consistent manner with positive goodwill, the second adopts the minimum observable value and the third is an entirely subjective estimate which accounting measures seek to avoid.

Example for negative goodwill which should be avoided

Let us take an example to clarify the argument so far. Earlier we have mentioned the example of a book seller who buys the van for £ 800. Let us assume that this book seller's van, in combination with his other assets and knowledge of the trade had a present value of £ 969. But the book seller would presumably not hesitate to accept say £ 900 for the van if he could replace immediately for £ 800. To the book seller the value of the van in isolation is simply current entry price. If changes in expectations force the book seller to adjust his present value downwards to say £ 700 (with entry/exit prices unchanged) he would continue to hold the van because it is worth more to him than the exit price of £ 600. But the £ 800 entry price becomes a value to him only in the devious sense that another

is the best available. The book seller's present value

identical van would cost him that much; it would not represent the loss (£ 700) he would suffer by being deprived of the van. The potential significance of this last qualification depends on the size of the margin between entry and exit; in general the margin will be widest for fixed assets which are specific to the firm's activities so that potential buyers are scarce and exit price is low.

Despite these difficulties exchange values offer information of current relevance to the firm's position, which is more than can be said for historic cost. Given that a choice has to be made between exit and entry prices as value concepts for accounts, which should be chosen?

It has been seen that exit price (net realizable value) would give the minimum value of separable assets to the firm, conforming to a view of the firm in which all assets were to be realized in the short run. But continuity is a more widely appropriate assumption for firms than dissolution, and for the continuing firm exit prices would give unduly conservative fixed asset values. For example, assets specific to the firm would have to be written down immediately on acquisition, with consequences for profit measurement in current and future periods.

Entry price (replacement cost) gives an approximate measure of value to the continuing firm. It is not a perfect measure, but it is the best available.²⁶ The basic arguments for replacement

cost valuation are that current costs (really current expenses) are matched with current revenue to derive operating income, that holding gains and losses are reported separately in the income statement and not mixed with operating income, and that the assets are reported in the balance sheet at current costs. In other words, the contention is that financial statements based on current costs (replacement-cost valuation) provide more useful information for financial decision-making purposes than do those based on conventional historical-cost valuation. Replacement-cost valuation avoids the problems of historical-cost valuation that results in the mixing of purchase prices of different periods, the mixing of operating and holding gains and losses, and the reporting of out-of-date, and therefore irrelevant, past purchase prices in the balance sheet.

Those accountants favouring replacement-cost valuation contend that the net operating income for the period should be the difference between current revenue and current cost (replacement cost at time of sale) of goods and services utilized (current expense) in the generation of the revenue during the current period. Current expenses should be matched with current revenue because the "true" cost of generating revenue is the cost to acquire goods and services to generate the revenue at the time of sale.

Under replacement-cost valuation, changes in the replacement cost of specific assets are segregated and reported in the

financial statements during the period when such price changes occur - holding gains and losses. The argument is that the timing of the investment in, the holding of, and the sale or use of assets (as well as liabilities) is part of management's job in operating the business efficiently. Consequently, it is argued that holding gains and losses should be reported in the income statement in order to report on which period's holding activities were successful or unsuccessful.

Under conventional historical-cost valuation, gains and losses for a fiscal period are not generally recognized until the assets are sold or used in production and sold as finished goods. For example, if merchandise inventory that originally cost £ 10,000 has a replacement cost of £ 11,000 at year end, there is no recognition of a £ 1,000 holding gain under conventional historical-cost valuation. If the replacement cost of the inventory is £ 10,500 when sold in the next period, then under historical-cost valuation there is a £ 500 holding gain that is not segregated but is mixed with operating income as part of the difference between sales and the historical cost of the inventory. Such valuation results in the failure to report a £ 1,000 holding gain in the first period and a £ 500 holding loss in the second period, as well as mixing of a "net" £ 500 holding gain (£ 10,500 - £ 10,000) with operating income in the second period. In contrast under replacement-cost valuation, holding gains and losses can be reported for the period when they occur.

By using the conventional revenue-recognition assumption with replacement-cost valuation, only those holding gains and losses that are realized by sale or use are reported in the income statement; hence, net income is the same for both replacement - cost and historical cost valuation. The only differences between the two valuation methods are that under replacement-cost valuation realized holding gains and losses are reported separately in the income, unrealized holding gains and losses are reported in the stockholders'-equity section of the balance sheet, and non-monetary assets and long-term liabilities are reported at current replacement cost. Thus, replacement-cost valuation has the practical advantage of being easily adapted to existing accounting practice, since it builds upon conventional historical-cost valuation in both the accounting records and the resulting financial statements, as well as being consistent with generally accepted accounting principles.

On the other hand, some accountants argue that both realized and unrealized holding gains and losses should be reported in the income statement. If this were done, then the conventional revenue-recognition assumption would have to be modified by the recognition of holding gains and losses as being earned when the asset is sold or used, or when the end of the accounting period occurs, whichever is first. Professor Edwards and Bell strongly advocate the adoption of a "business profit" consisting of: (a) current operating profit - the excess over a period, of the current value of output sold over the

current cost of the related inputs, and (b) realizable cost savings + the increase in the current cost of assets while held by the firm during the fiscal period.²⁷

This, of course, consists of the specific current cost profit advocated in his work, plus "holding profits". They, however, do stress that these two components be recorded and reported separately in order to prevent misconceptions.

Advantages of their "business profit", they say, are that:

"the managerial evaluation of expectations is facilitated because gains of one period are recorded in that period and gains from holding activities are sharply distinguished from current operating profit. Data are available for reporting current values on the balance sheet, making this report of greater significance to financial analysts, owners and the public. It would also provide better raw data for measuring the nation's stock of wealth." (28)

Professor Bell contends that it is the accountant's function to measure a firm's performance (profits), so that it can be compared with management's plan of operations and thereby provide the means to evaluate the plan.²⁹ Since current cost (replacement cost) represents the cost of assets management has chosen to use in its plan of operations, then current cost (expense) should be matched with revenue to measure operating success or failure. Once the operating plan has been evaluated,

then management can decide whether to attempt to change future performance by selling or holding assets and the like. Consequently, historical-cost valuation is rejected because it does not provide current-cost data to measure performance. Similarly, selling-price valuation is rejected because it does not measure past economic events that actually occurred, and therefore does not provide the means to evaluate performance in terms of what was expected via management's plan of operations.

Replacement-cost valuation is not without its limitations. It has prospects of being quantified with some degree of objectivity, but it would often be necessary to regard replacement cost of the particular asset under consideration as a measurement aim which is not precisely achievable. Current entry prices for identical assets (especially those which are partly used) are often not known or at least not available to the firm in a readily accessible form; consequently the application of replacement cost must involve estimation. It may be noted that most firms do have some readily available estimates of replacement cost of asset in the form of valuations for insurance purposes; disclosure of those estimates to shareholders would not be unduly burdensome.

There is also the question of what exactly replacement cost is. Is it the cost to replace the asset in its present form (replace the exact asset), or the cost of replacing the

capacity to produce? This is especially important when there have been technological changes. That is, because of technological changes, a firm's existing equipment may not be able to produce the quality and quantity that new equipment can. In such a situation, what is replacement cost?

The AAA Approach:³⁰ As defined on the various committees of the American Accounting Association, current cost is the cost of replacing the specific asset consumed in the generation of revenues. If, because of technological advances, the specific asset is no longer available, the cost of acquiring services equivalent to those provided by the asset consumed is substituted.

The Edwards and Bell Approach:³¹ This is quite similar to the AAA approach, except for the recommendation that the current cost of the actual assets employed or consumed, not the current cost of equivalent assets, be deducted from revenues in arriving at current operating profit. They assert that operating income determined in this manner will reveal, through interfirm comparisons, the truly efficient productive processes.

Also, replacement cost, like any other measure of the value of the separable assets of the firm, will not represent the value of the firm as an entity. The value of the firm as a

whole can be considered to be the present value of expected future cash flows: such value depends on the complex organizational inter-relationships of assets which in the last resort depend upon the abilities of management and other employees. Nor does the adoption of replacement cost give what is termed reproduction cost of the firm (the total cost of setting up a comparable firm ab initio); clearly many organizational factors like staff training and customer contacts are ignored. Of course what can be regarded as a separately identifiable asset for accounting purposes is itself a debatable matter: any current resources committed in the expectation of future benefits are eligible, and for conceptual consistency such items as Research and Development (R & D), patents, and advertising expenditure would have to be valued at the replacement cost of the benefits still accrued. Subjective estimates would be inevitable, but arguably more informative than the present diversity of conventional accounting practice.

5.5.6 Income Concepts

The discussion of value has narrowed the income concepts to be considered. Income will be examined from the viewpoint of accounting measurement in the light of the earlier conclusions on value to the firm.

An income measure must be considered in relation to the purpose for which it is to be used. There are many possible purposes; we shall briefly consider four major candidates before turning to measurement. The list is not exhaustive; our primary concern is with the first two possibilities.³²

(a) Appraising Performance: A profit measure can assist in the appraisal of the success with which a firm's operations have been conducted. If profit (income) represents the increase in one period of the net resources owned by the firm (after adjusting for contributions from, or distributions to, shareholders) it provides a *prima facie* indicator of successful operations.

Appraisal implies some expectation of what performance should be and power to investigate and take action on adequate performance; detailed data required for this essentially managerial function within the firm will not be considered here. However, the accounts of the firm as a whole can assist self-appraisal by the firm's controlling management, or appraisal by controlling shareholders. Non-controlling shareholders normally have relatively little power to appraise in the sense used here.

(b) Projecting Performance: Existing and potential shareholders must usually take a relatively passive view towards

income; for the widely owned firm an investor's personal assessment can rarely be translated into action to affect profitability directly and his major sanction is the vote by either buying or selling shares.

Consequently investors are primarily interested in profit as a starting point for share valuation. Certainly the most commonly used indicator in relation to share prices is the price/earnings ratio (current market price per share divided by profit after tax per share), which implies that profit earned by the company in the last accounting period has some bearing on share price. The ideal profit measure for investors might be a current period estimate of the annual increment in net resources which could be maintained in future years: many reasons, not least subjectivity, make this ideal unattainable, but it is possible that shareholders may prefer a profit measure which attempts to eliminate apparently short-run fluctuations. For present purposes however, it will be assumed that a measure of the increment in net resources, together with sufficient information on fluctuations, would serve investors equally well.

(c) Determining Dividends: A company intent on using its resources to the advantage of shareholders would employ available cash to obtain a higher present value than would be available to the shareholders in general and would distribute to shareholders (either as dividends or return of capital with

sanction of the courts) cash which could not be so employed. The analysis would be vastly complicated by such considerations as taxation, the transaction costs of distribution and raising cash and the selection of the appropriate interest rate for discounting, but the principle remains that it is cash generation in relation to available opportunities which is the primary consideration: a profit measure is not essential for this purpose.

Profit does influence dividend payments in at least two ways. Firms commonly adopt a policy of paying some proportion of 'normal' accounting profit as dividends: the fact that such pay-out ratios differ between firms and change for a single firm over time supports a view that profit is used largely as a surrogate for the generation of available cash in the long run, although shareholder expectations affecting share price provide a further complication in dividend policy. The law requires dividends to be paid only from current or past profits: this stems from an intention that capital should be 'maintained intact' (originally for the safety of creditors), but the law allows considerable latitude to companies in their measurement of profits.

(d) As a Base for Taxation: From the taxation viewpoint, profit is merely an indicator of ability to pay tax. There is no reason why profit for taxation should coincide with profit measured for other purposes, and indeed there are already very

considerable differences between accounting profit and taxable profit.

5.3.7 The Definition of Income and Income Measurement: Attention can now be directed to profit (income) as a measure of the firm's performance, which will be assumed to serve the first two purposes considered above, especially the second purpose where the most important need for the concept of income is as a guide to investment policy. Prospective shareholders (investors) seek to maximize their return on investment, and their search will be guided by the income earned on existing investments. This is related to another argument - that income provides the best measure we have of success in the management of business enterprise in a competitive economy. These are important needs, and they both point in the same direction. That investment is most attractive which offers us the greatest present value of future receipts per pound invested, when discounted at the going rate of interest, and in so far as historical data can help us in the choice of investments, it will be data about the growth in present value of existing investments. Again, that manager is most successful who, during a given period, increases the present value of the enterprise entrusted to him proportionately the most. In both of these cases, it is growth in present value which alone appears to be significant; and since it seems to carry out the function generally attributed to income, growth in present value must be what we had better understand income to mean.

The Economist's Conception of Business Income: The concept of income to which we have been laid corresponds to the Economist's conception of Income.

Income determination is not confined to the exclusive jurisdiction of accountants. The economist has been particularly concerned with the development and refinement of income theories. Irving Fisher, a celebrated American economist, ascribed a most prominent role to income when he declared:

"I believe that the concept of income is, without exception, the most vital central concept in economic science and that on fully grasping its nature and interrelations with other concepts largely depends the full fruition both of economic theory and its application to taxation and statistics." (33)

Unlike the accountant, the economist has not adopted an all embracing theory of income. In this connection, John B. Canning states:

"The greatest difficulty, perhaps, that presents itself is this: The accountants can properly be said to adhere to one highly unified and intricately articulated theory; economists, on the contrary, have brought forth many theories very unlike one another; and at no time can they be said to have been in substantial agreement." (34)

The economist does not, like the accountant, consider income and profits to be synonymous. In its most general sense,

economic income consists of scarce services which "..... proceed ultimately, from material objects, but under no circumstances are material things income; these belong to a wholly distinct, though related category."³⁵ Profit is regarded as one of the distributive shares of income together with rent, wages and interest.

Beginning with Adam Smith, many economists have viewed income as existing only after capital has been maintained.³⁶ Currently, the most commonly accepted definition of economic income is Hicks's:

"The purpose of income calculations in practical affairs is to give people an indication of the amount which they can consume without impoverishing themselves. Following out this idea, it would seem that we ought to define a man's income as the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning. Thus, when a person saves, he plans to be better off in the future; when he lives beyond his income, he plans to be worse off. Remembering that the practical purpose of income is to serve as a guide for prudent conduct, I think it is fairly clear that this is what the central meaning must be." (37)

To use Hick's definition for the income of a business entity rather than for that of an individual, we need only modify it slightly; the income of a business entity is defined as the maximum value which it can distribute during an accounting period to its owners, and still expect to be as well off at the

end of the period as it was at the beginning. It is assumed for purposes of this definition that no further capital is introduced into or withdrawn from the enterprise during the period.

The crux of this definition hinges upon what we mean by the term "well off". It is clearly a concept which is equivalent to the accountant's notion of equity, or net asset value, and it is evidently a future-oriented concept, since all the benefits from being "well-off" reside in the future. To be equally well off at these two points means that capital must have been maintained, and this raises the issue of how capital maintenance is to be measured. In economic terms, well-offness can be defined as the present value, using an appropriate rate of discount, of the expected stream of future net cash receipts of the enterprise.

Capitalized Net Receipts: As we have already seen when discussing "Value theory" above, the value of the capital invested in any undertaking can be measured by discounting its expected net cash receipts by an appropriate discount rate. Assume for example, that a firm expects a net cash inflow of £ 1,000 at the end of each of the next three years, 1971, 1972, and 1973. The £ 1,000 may be an expectation known with certainty or it may be the average of a possible range of receipts, each weighted by its probability of occurrence. If, in view of alternatives available, the management of the firm

would not undertake this investment unless it earns at least 10 per cent (the target rate), the present value of this investment is £ 2,487.

Of the £ 1,000 received during the year 1971, £ 249 is income and is computed as follows:

Cash received	£ 1,000
Discounted value at end of 1971 of 2 annual expected cash receipts of £ 1,000	£ 1,500 1,736
Total value at end of 1971	£ 2,736
Less: Value at beginning of 1971	2,487
Income for 1971	£ 249

The remainder of the £ 1,000 received is a return of capital. If the payments are certain, the income for the year can also be computed by multiplying the capitalized value of the investment at the beginning of the year by the discount rate ($£ 2,487 \times 10$). The £ 249 is called the subjective income for the year since it represents the change in the subjective value of the firm from the beginning to the end of the year.

Subjective income may be computed before or after the period to which it relates has expired. In its expected sense, it represents the expected change in subjective value between two dates. In its actual sense, it includes expected income as well as unexpected gains and losses.

In the above example, expected subjective income and actual subjective income are the same because expectations were realized and remain unchanged. Assume now that the actual cash received in the first year was £ 1,500 and that expectations changed so that two future net cash inflows of £ 1,000 are expected at the end of the next two years. The income for 1971 is computed as follows:

Cash received	£ 1,500
Discounted value at end of 1971 of 2 annual expected cash receipts of £ 1,100	£ 1,910
Total value at end of 1971	£ 3,410
<u>Less:</u> Value at beginning of 1971	<u>2,487</u>
Income for 1971	<u>£ 923</u>

This £ 923 actually consists of several elements:

Expected subjective income (£ 2,487 x 10)	£ 249
Unexpected cash receipt in 1971 (£ 1,500 - £ 1,000)	500
Increase in subjective value at end of 1971 (£ 1,910 - £ 1,736)	174
	<u>£ 923</u>

Economists tend to disagree about whether the £ 923 is income for 1971 in its entirety. Because expectations for the year were exceeded and future expectations changed, the beginning value of £ 2,487 was not the actual subjective of the firm at the

beginning of the year. Consequently, it is argued that a part of the \$ 923 is more properly viewed as a correction of prior-year incomes than as an element of current income.

Economic income consists of two presumably separable elements, "real income", from operations, and "unexpected gain" or adjustment of incorrect equity at the beginning of the period. It is contended that "unexpected gains occur only as a consequence of "conditions of uncertainty".

If actually applied in a manufacturing company, subjective income would undoubtedly include:

- (i) income realized from delivery and sale of product;
- (ii) unrealized income from increases in value resulting from the production of goods not yet sold;
- (iii) realized gains and losses of an unexpected, windfall nature; and
- (iv) unrealized changes in capitalized value resulting from either internal (changes in efficiency) or external (changes in demand) factors.

It is apparent that economic income is dependent on equity valuations. We have seen above that the economist is concerned

with entity rather than individual asset valuation since it is assumed and properly so, that the value of a concern will rarely be equivalent to the aggregate of its individual assets (less liabilities). The difference is referred to as "going value" and is incomparable to the accountant's "goodwill" when initially recorded.

As far as accounting income is concerned, it is the figure which links the net worth of the business as shown by its balance-sheet at the beginning of the accounting period with its net worth as shown by its balance-sheet at the end of the period, but accounting income only requires that we evaluate net assets on the basis of their unexpired cost.

It is hardly open to question that you cannot really assess the well-offness of an enterprise by aggregating the costs, or the unexpired costs, of its assets and deducting its liabilities. Any differences between the current value of its tangible assets and their book value based on cost will be excluded; and any value which the enterprise may have over and above the value of its tangible assets will also be excluded. We may sum up the relationship between these two different concepts of increase in net worth, economic income and accounting income, by starting with accounting income and arriving at economic income thus:⁵⁸

Accounting Income

- + Unrealized 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 realized this period in respect of value changes in intangible assets which took place in previous period and were not recognised in those periods,
- + Changes in the value of intangible assets during the period, hereafter to be referred to as changes in the value of goodwill.

= Economic Income

Income is an abstract concept and as such the logic of the Economist's version can hardly be refuted. Unfortunately, it is somewhat sterile and in its pure form is almost entirely devoid of accounting application. The major limitation of the economic concept of income is that, as a practical matter, it cannot be rendered operational because it is so heavily based on unverifiable, subjective expectations. And because it is so based, income can vary widely simply by changing the estimates of the amounts or the periods of cash flow expected or by varying the discount rate. Even if there is no intent to mislead, bias is apt to be present simply because of the difficulty of distinguishing between

emotional opinion and realistic estimates of future receipts.³⁹

Moreover, as Professor Kaldor has pointed out, although it is a concept of income which aims to maintain capital intact, one has to tread warily since "we cannot first define income as what is left after maintaining capital intact and then define the latter as what is required to maintain income intact, without getting involved in circular reasoning."⁴⁰

Hicks was well aware of this difficulty and he redefined income in ex post terms as the amount of net dividends plus the increment in the money value of the entity's prospect which has accrued during the accounting period; it equals distribution plus capital accumulation.

Hicks went on to say, "This last very special sort of 'income' has one supremely important property. So long as we confine our attention to income from property, and leave out of accounts any increment or decrement in the value of prospects due to changes in people's own earning power (accumulation or decumulation of 'human capital'), income ex post is not a subjective affair like other kinds of income: it is almost completely objective. The capital value of the (entity's) property at the beginning of the period is an assessable figure; so is the capital value of the property at the end of the period; thus, income ex post can be directly calculated."⁴¹

This concept of income will be objective provided we can find an objective measure of the money value of the entity's capital. If we are successful in our search we will have a concept of income which aims, like historical cost accounting, at the maintenance of money capital intact. However, it is only in the long run that the two concepts will coincide, and in any given year they are likely to give quite different measures of income.

Thus, if we are to translate the Hicksian concept of income into practical terms, we must define a measurable concept of value which avoids the circularity against which Kaldor warned. The economist's definition links income and value in much the same way that the double-entry system links the income statement with the balance-sheet, and this augurs well for the ultimate practicality of the approach we followed in our discussion of "value theory", earlier in this chapter.

In our discussion of "value theory", what we were looking for was an operational definition of what we meant by the value of an asset to a firm in current terms, that is to say in terms of current prices rather than in historical costs. Whilst we must note the importance of "economic value" (i.e. the net present value of the expected stream of future net receipts attributable to owning the asset in question), since the measure of this value determines whether it is worth while acquiring or retaining any given asset, we must also recognise that the

subjectivity of the concept makes it useless for objective accounting purposes.

In our discussion of "value theory", we found that the two current objective values which can be attached to an asset are its replacement cost and its net realizable value. What we had to decide was which of these two was the relevant measure of value for use in the determination of income. For reasons previously advanced in relation to value, and subject to certain limitations, already discussed previously, a measure based on the replacement cost of resources becomes appropriate for use in the determination of income.

5.4 CONCLUSION

In this part of the thesis, our aim was to outline an alternative measure of profit to that currently offered in financial reports. In trying to arrive at a reasonable measure of profit and taking into consideration the objectives we had set, much help was taken from the discipline of Economics. Why did we turn to the discipline of Economics?

Business enterprises are engaged in economic activities - buying and selling goods and/or services, processing goods and financing these activities. At the level of the firm, which is one of the basic units of organization in the economy, we are confronted with the central problem of economics, viz. that resources are scarce relative to wants, and it is necessary for

someone to decide what should be produced, how, when, and how much. Economists assert that the correct application of economic principles by consumers and firms will bring about optimal efficiency in the allocation and utilization of scarce resources in relation to, and in competition with, all the other wants of the community, or at least such of those wants as can be made effective with purchasing power.

It seems reasonable to suggest that accounting should assist in the achievement of this objective. It should contribute to greater efficiency in the use of scarce resources by measuring past business performance in a way which fairly truthfully and unambiguously represents economic reality, making it possible to draw the correct economic inferences from the information and learn the correct lessons of the past. Similarly prospective accounting should guide managements and investors to make future plans and decisions which are economically sound and consistent in the light of their present knowledge, by correctly specifying the data which will in large part influence them in forming their expectations. How well conventional business accounting acquits itself in this role, and how it might be reshaped to meet this requirement remains to be seen.

CHAPTER SIXCONCLUSIONS6.1 ECONOMIC PROFIT AND ACCOUNTING PROFIT

After going through the thesis, one would be tempted to conclude that the term 'profit' is used in two different senses in Economics and Accounting. This notion is not incorrect. The Economic Profit and the Accounting Profit are not one and the same thing. They differ from each other. Once again we would like to make it clear that the main purpose of this thesis was to show separately the concept of profit in Economics and Accounting (note the word profit). The Economist does not, like the accountant, consider income and profits to be synonymous. In its most general sense, economic income consists of scarce services which ".....proceed, ultimately, from material objects, but under no circumstances are material things income; these belong to a wholly distinct, though related category."¹ Profit is regarded as one of the distributive shares of income together with rent, wages and interest.

A secondary purpose of the thesis was to outline an alternative measure of profit to that currently offered in financial reports. In attempting this secondary task, we did refer to the economic concepts of Income and Value.

6.1.1 Economic and Accounting Profit Compared

The question now before us is: what is the relationship between 'Economic Profit' and 'Accounting Profit'?

The answer to the above question is not so easy to give. As has been shown, the Accounting treatment of profit is not uniform in the case of different forms of business organisations. It differs from one form to another. Moreover, it is not the same for all types of business. Similarly all the economists are not strictly unanimous on what profit is.

However, let us try to seek a relationship which may hold good inspite of all these diversities. We can say that the relationship between Economic Profit and Accounting Profit is that in the estimation of profit we take only "explicit costs" into consideration in accounting, while in economics we take into consideration "explicit costs" as well as implicit costs". By "explicit costs" we mean the actual costs for which money or money's worth is paid, any liability is incurred or the accrual is recognised in the books of accounts. On the other hand, "implicit costs" are those costs that relate to a particular economic event, or commitment, although no conventionally accepted exchange transaction has then occurred. For example, some economists argue that one of the costs of an enterprise to be accounted for is the implicit interest (or cost of capital) on the owner's investment. Although there is no cash or price-oriented transaction which is evidence of this commitment,

an acceptance of the entity theory implies an independence of the business entity and the owners. Therefore, it follows that as between the entity and its owners an implicit transaction may be imputed. Total costs would be increased by such imputed interest; necessarily the cost increase is also indicated by a contra increase in the equity of the owners. The residual profit after all expenses are considered (including the cost of each equity element) represents excess profits which accrue to the entity itself. Since the objectivity of such an imputation does not accord with present accounting standards, this type of cost is not currently recognised for reporting purposes. A natural corollary to this is that the accounting profit will always be greater than the economic profit.

Though it is very difficult to give a complete list of the items of the costs which we deduct in order to arrive at the figure of economic profit but do not do so while finding out the figure of economic profit, the following are some of the items:

- (i) Remuneration of the owner(s);
- (ii) Rent of the self-owned land;
- (iii) Difference between the economic rent and contractual rent in respect of other lands;
- (iv) Interest on the capital invested by the owner(s).

Sometimes the remuneration of the owner(s) is not included in the operating expenses of the business. If the owner works for the business, his salary must form a part of the operating expenses just as the salaries of the staff are included in the expenses of the business. In order to arrive at the economic profit, this must be done. The remuneration of the owner should not be fixed arbitrarily. It should be equal to the sum, the owner is able to get if he seeks a job with some other business concern.

Sometimes the rent of the self owned premises is not included in the operating expenses of the business. If it is desired to arrive at the economic profit, the rent of such land must be included in the operating expenses of the business. The rent of the premises should be fixed at the amount which the business can earn by letting out the land on rent.

Generally the business does not pay the full economic rent in respect of the land held by it. If there is any difference between the economic rent and the actual rent, the same should be taken into account in order to get the figure of economic profit.

If a business borrows funds from outside sources, it has to pay interest on it, and the interest charges are included in the operating expenses of the business. But surprisingly

enough, no interest is recorded on the capital invested by the owner(s). It looks all the more surprising when we consider the fact that in accounting the owner(s) and the business are considered to be two separate entities. In order to arrive at the economic profit, this must be done. The rate of interest must be the same as is allowed on the capital borrowed from elsewhere in the market. Similarly interest should be charged on the drawings of the owner(s). The rate of interest should be equal to the amount which the business can earn if it decides to invest its funds outside the business.

Now let us try to be more specific and examine the above in the case of:

- (i) a Sole Trading concern;
- (ii) a Partnership Firm; and
- (iii) a Joint-Stock company.

(i) Sole Trading Concern: In a sole trading concern all the above items are not taken into account. No remuneration is allowed to the owner(s), no rent of the self-owned premises is taken into account, the difference between the economic rent and the contractual rent is not accounted for and no interest is allowed on the capital of the owner. The following illustration will make the point clear:

Salim, a sole trader invested £ 40,000 in his business. The Profit and Loss Statement for the year shows a profit of £ 15,200. No remuneration is paid to the owner, though he can get a job carrying a salary of £ 500 per month outside his business. Interest charges at the rate of 5% on borrowed capital were included in the operating expenses of the business, but no interest was allowed on the capital of the sole trader. No rent of the self-owned premises was charged to the Profit and Loss Statement though the premises can be let out on an annual rent of £ 5,000. The business pays £ 800 as annual rent of the office premises but it is estimated that the economic rent of the premises is £ 1,000. The sole trader did not withdraw any amount during the year.

The economic profit of the above concern will be determined as follows:

<u>Profit as per the Profit and Loss Statement</u>		£ 15,200
<u>Deduct:</u>		
Remuneration of the owner (500 x 12)	£ 6,000	
Rent of the self owned premises	5,000	
Difference between economic and actual rent (1000 - 800)	200	
Interest on Capital (5% of 40,000)	2,000	13,200
<u>Estimated Economic Profit</u>		<u>£ 2,000</u>

(ii) Partnership Firm: In a partnership firm, usually interest is allowed on the capital of the partners, interest is charged on the drawings of the partners, and salary is allowed to the active partners. But all these adjustments are made in the Profit and Loss Appropriation Account and not in the Profit and Loss Account as such. Moreover, the rates of the interest and the amount of the salaries are based on contract and not on the opportunity cost. As such all the adjustments needed in the case of a sole trading concern in order to arrive at the figure of economic profit are also required to be made in the case of a partnership firm.

(iii) Joint Stock Company: Due to the separation of the ownership and control in the Joint Stock Company, the cost of management forms a part of the operating expenses of the business. There is no question of the drawings by the shareholders. If the company advances any amount to the outside parties, it charges interest on that amount, and the amount is shown under the heading 'other income' in the profit and loss statement. The possibility of any land owned by the shareholders and in use of the company is also very remote. However, in a Joint Stock Company:

- (1) the difference between economic rent and actual rent is not taken into consideration similarly as it is not in the case of a sole trading concern and a partnership firm;

- (ii) no interest on share capital of the business is allowed, though interest is allowed on the funds borrowed from the creditors;
- (iii) opportunity cost is not taken into consideration, but instead contractual cost is taken into account.

From the above discussion it will be clear that the gross profit as determined by an Accountant and by an Economist are identical, but the net profit determined by the two will differ. The reason for this is that an accountant takes into consideration only the "explicit costs", while an economist takes into account "explicit costs" as well as "implicit costs". By the implicit cost we mean the opportunity cost of the self-owned assets.

If we deduct from the Accounting Profit "implicit costs" we arrive at the figure of economic profit. Similarly, if we add in the figure of economic profit "implicit costs", we get the figure of accounting profit.

Spahr et.al. have compared accounting profit and economic profit as under:

"The accounting definition of profit is simple and adequate for use in business records. But economists are interested in discovering in what way profits constitute a type of income distinct from other incomes. They are interested in pure.....

...profits, after deducting all rents, interest, and wages, whether paid out to others or whether allowed by the enterpriser for his own land, buildings, machinery, capital funds and his own labour. The economist's problem is to discover the factors determining the size of profits in relation to other economic shares. The fact that profits are residual in income accounts constitute no explanation. Although the enterpriser must take as his share whatever is left at the end of the year, he is by no means completely helpless. By adjusting future contracts and investments he exerts a definite influence upon his own and others' shares. The economic problem consists of determining in just what way this influence is exerted, what limitations are upon it, how it compares with influences originating with wage earners, capitalists, and those who rent buildings, equipment, and natural resources." (2)

In accounting, profit is always something over and above cost. But in Economics, profit represents a factor return. In perfect competition, profit forms a part of the costs of the business. In monopoly and imperfect competition, however, it becomes a residual - the excess of income over costs. In monopoly and imperfect competition, as such, profit as determined by an accountant and by an economist get closer to each other. Further, the separation of ownership and control in a Joint Stock Company has led to the narrowing of the gap between economic profit and accounting profit, as most of the items which are responsible for the difference in the economic profit and accounting profit are eliminated.

6.2 IMPORTANCE OF ACCURATE DETERMINATION OF PROFIT

As was pointed out earlier, it is very important that the profit of the company should be determined accurately, as there are many parties interested in the profits of the company. The case of a sole trading concern and a partnership firm is somewhat different as only a few persons are interested in their profits. The importance of the true determination of profits for some of the parties is as under:

(1) To the Business Firm: The periodic figure of profits of a company generally form the basis for the formulation of the future policies. If the profits are not calculated accurately, the company may not be in a position to take appropriate steps in order to bring about desired changes. The comparison of the profit figure with those of the previous periods and the calculation of the various ratios help a lot in determining the efficiency or otherwise of the operations of the company. If a company wants to remain in the market, it must avoid wastes and inefficiencies in this competitive world of today. If the profits are not determined accurately, they may misguide the management.

(2) To the Government: The Government is interested in the profits of the company as it has to levy taxes on the profits. Until the true profits are determined, the correct amount of taxes to be recovered from the business cannot be fixed. If the

income tax authorities are not satisfied with the manner of the determination of profits, they are empowered to levy taxes according to their own formula, disregarding the profits disclosed by the books of accounts maintained by the company. Moreover the government desires to know the true figure of profits in order to grant subsidies, provide incentives, give exemptions or impose restrictions, etc.

(3) To the Shareholders: The shareholders of a company look to the profits of the company in the anticipation of dividends. The Directors of the company declare dividends on the strength of the earnings of the company. If the earnings of the company are not calculated accurately, the directors may declare dividends without due regard to the financial implications of the dividends. The investors are attracted to purchase shares of the company if they find that the earnings of the company are good. If the earnings are not determined accurately, the would-be shareholders may be misled and may not be able to form a sound judgement whether to invest in the company or not. The existing shareholders may also be misguided and they may decide to liquidate their holdings in the company which will have a bad effect on the shares of the company in the stock market.

(4) To the Employees: The employees depend on the profit of the company for their bonuses and increment in their remunerations, etc. A high figure for profits may be due

to the efficiency of the employees. On the basis of the profit figures, the trade unions, representing the employees, usually fight for bonuses and other facilities.

There is not one concept of profit (or income) which is suitable for all purposes or which could be claimed to be the "true" profit for the period. It must be recognised that for different purposes we need different concepts of profit, and in each case a choice must be made as to the concept which is relevant to the use to be made of the profit determination. It is the suitability of the concept for the purpose which should be the decisive factor in any choice of a concept of profit (or income).

6.3 THE OBJECTIVES OF FINANCIAL STATEMENTS

We have already referred to certain uses of an income measurement in chapter five and in section 6.2 of this chapter. A secondary purpose of the thesis was to outline an alternative measurement of profit to that currently offered in financial reports. Our study in chapter five was limited to financial statements as prepared for parties external to the firm - primarily investors and creditors. However, matters appertaining to management were not ignored, because management is heavily constrained by shareholder expectations. However, we must recognise that those external to the firm will be requiring information for purposes different from those internal to the firm. Such information though not different from that available internally may require to be more selective.

6.3.1 General Considerations³

It has been suggested that accounting can be defined as "the process of identifying, measuring, and communicating economic information to permit informal judgements and decisions by users of the information."⁴ This definition highlights two matters central to any discussion of accounting statements - communication and information.

The problem of communication is not limited to accounting; it is one that permeates the whole society and its activities. Similarly within accounting itself, communication is not only of significance with regard to external reporting; it is equally important for internal reporting. Wherever there is transmission of information from the informed to the uninformed there is the problem of communication. Central to the problem is the difficulty of conveying meaning, for this requires that both parties to any message understand the language. With accounting statements prepared for external use the difficulty is increased because the two parties rarely have the opportunity to make further explanation to, or enquiries from, each other. It is imperative therefore that there is some pre-arranged code, some common understanding of the significance of the symbols used in the statements. Unless there is this prior agreement the receipt of information will be accompanied by uncertainty and misunderstanding.

It is because of this need for a common language, and because accounting statements are the mass media of the investment world, that there has been a move towards uniformity in financial reporting. Further comparability is an essential characteristic of the information required by investors.

Although uniformity in accounting statements is an important prerequisite to successful communication, the information content of any message is of deeper significance. It seems reasonable to require that, given the scarcity of economic resources, the communication of accounting information should be useful to the predetermined needs of users of accounting statements. The important question before us is, what are the qualities required of information for it to be classed as useful?

The answer to this question suggested in A Statement of Basic Accounting Theory⁵ is that there are four basic standards to be taken as criteria for evaluating potential accounting information. The primary one is considered relevance, the others being verifiability, neutrality and quantifiability. To be classified as relevant, information "must bear upon or be usefully associated with the action it is designed to facilitate or the result it is desired to produce."⁶ The implication of this test, or perhaps the assumption underlying it, is that the user of financial statements is one who is faced with alternative choices of action. In the context of the category of

users with which we are concerned this assumption seems acceptable. Decision making is central to their activities: the creditor whether to loan or not; the shareholder whether to hold or sell, whether to retain or replace his steward; the prospective investor whether to buy or not.

Besides relevance, two of the other standards - verifiability and neutrality or freedom from bias - would seem particularly pertinent to external accounting statements. Assuming information by definition to be relevant, such information must be reliable. This is of course desirable in any context where decisions are made on the basis of processed information. If users are to act on the basis of information received they must be able to rely on it. The existing shareholder needs to know that there is no bias in the information presented that might encourage him to sell when he should hold. He needs to know that the accounting measurement procedures have not been manipulated in such a way as to present a stable trend of earnings, just because management believes that this is what investors want to see. The prospective investor or creditor wants to be assured that certain figures have not been inflated in order to encourage a flow of new funds into the business or to appear more creditworthy than is actually the case. Verifiability and neutrality are thus both aspects of the need for reliability. Reliability, though, is but an aspect of relevance. First and foremost it is relevance that matters: in

achieving this it may be that different levels of reliability have to be accepted. Records of the past and estimates of the future may both be equally relevant, but quite clearly the latter is less verifiable and more open to bias (conscious or not) than the former. Consequently one may be considered more significant or material (but not 'relevant') to the decision than the other. In the final analysis it is probable that there is some sort of compromise whereby certain information is found to be so unreliable that it is no longer significant, while other information is considered to be so significant that a low level of reliability becomes acceptable.

Finally, we need to look at the respective roles of the information processor and the information receiver. In communicating information who decides what to communicate, which data is relevant and which information is reliable? Quite clearly for communication to be necessary in the first place the receiver is in no position to select for himself at any particular moment the information he would like to receive. At the moment of communication he is very much in the hands of the processor. Equally, the processor's prime responsibility is to be aware of the receiver's needs. This in itself poses no great problems. Where problems can arise is in deciding what data is relevant to the user's needs. The difficulty usually is that neither party in fact knows what is relevant. Given our present lack of knowledge it seems

that it must be to the benefit of all for both parties to the communication process to pursue research into the relevance of data to particular needs. Even more certain is that the accountant, in his position as information processor, must recognise that his is a service role and that it is incumbent upon him to maintain close contact with the user whom he serves, in order that he may constantly improve the effectiveness and relevance of his communications.

In spite of the processor's role in determining what information is to be communicated it must nevertheless be emphasised that his function is fundamentally different from that of the receiver. Whilst he must be aware of the latter's needs, his awareness must in no way colour or bias the information he transmits. It remains the function of the receiver to evaluate the information according to his needs; interpretation is not within the job specification of the processor. In the context of reporting to parties external to the corporation, it is not therefore the function of the accountants to in any sense value the firm. He may seek to provide information which meets that need, but the process of and responsibility for that evaluation must rest firmly on the investor or creditor.

6.3.2 Overall Purpose of Financial Statements

Information on Economic Resources: Bearing in mind the considerations discussed above, we can say that the overall purpose of financial statements is to communicate information

concerning the nature and value of the economic resources of a business enterprise, the interests of creditors and the equity of owners in the economic resources, and the changes in the nature and value of those resources from period to period.

Economic resources are defined herein as those elements of wealth that possess the three basic characteristics of utility, scarcity and exchangeability and hence have economic value.

"Exchangeability" as the term is used here is not intended to suggest that an economic resource is necessarily immediately marketable or that it is being held for immediate sale. Rather, exchangeability means that an economic resource is separable from a business as a whole and that it has value in and of itself - that it is not solely dependent on the fortunes of the particular business enterprise to which the resource is attached.

The valuation process relates essentially to economic resources and not to the interests of creditors and owners in those resources. Accounting for liabilities and equities involves accounting for the rights to the resources.

Earnings Concept: The value approach advocated for the balance sheet also determines the related earnings concept. If earnings are to be considered a result of the measurement

of economic resources, the periodic earnings will be determined by the change in the owners' equity shown by comparative balance sheets, after a provision for the maintenance of owners' capital to reflect the effects of significant inflation and after recognising additional investments by owners and distributions to owners. In other words, the earnings concept is ultimately based on the changes in value of the economic resources.

Why the Value Approach in the Future?

Why the Value Approach? Transactions would undoubtedly continue as the major criterion for value-change recognition on a wide scale. The statement of the overall purpose of financial statements does not contemplate a wholesale abandonment of the transaction-oriented cost approach. Transactions translate values into cost that under many circumstances will be a continuing dependable and reliable means of conveying value information about economic resources.

Changes in value in economic resources.

There should be a basic change in attitude that will acknowledge value as a goal so that cost will be regarded as a means of conveying information about value, rather than being viewed as an end or objective in itself. The relevance of cost would be properly challenged when major changes in value in economic resources clearly emerged. Otherwise, financial statements will not be fair to the diverse conflicting interests of the users - for example, the interests of the potential buyer versus those of the potential seller of stock.

Presentation of value-based information on economic resources in financial statements should be of great relevance to investors, creditors and others who use financial statements. This information indicates the economic strength of a business enterprise and, together with the historical record of accomplishment, should provide an important basis upon which to judge the capacity of the enterprise to produce and enhance its economic resources in the future.

Substantially all economic decisions that run from financial information concern the future. Financial statement users make assessments of the future that are based in part on information about current economic strength and past performance displayed by the financial statements. This central role of financial statements will obviously be served best if the information is based on current data concerning values and changes in values in economic resources.

Current-value information concerning economic resources enables the investor to make a more meaningful comparison of the market price of the stock of the company with those values, thus providing a better measure of the current premium an investor would pay in anticipation of future earnings. Similarly, the creditor has an interest in values in relation to his interests. It is difficult to see how any debt-asset or debt-equity ratios can be significant or be other than misleading

unless amounts assigned to economic resources provide some reasonable measure of value.

The value of an economic resource at any time is the price it commands in exchange. Value may be indicated by an initial cost, by cost to reproduce a similar product or service, by a market price (market selling price or market buying price) or by reference to values of other economic resources that would provide comparable services. The question of the most appropriate value to use in various circumstances will involve difficult areas of judgement, but these difficulties must be faced if financial information is to be made relevant and useful.

Summary of the Results from Chapter Five: In chapter five we outlined an alternative measure of profit to that currently offered in financial reports. In that chapter the matter of valuing networth and individual assets by discounting future estimated cash flows (in and out), using an appropriate discount rate, was discussed. It was said that this method of obtaining present value of assets was not practicable for accounting purposes.

The American Accounting Association's Committee on Concepts and Standards - Long-lived Assets puts the matter very well:

"We affirm the definition in the 1957 Revision that "Assets are economic resources devoted to business purposes within a specific accounting entity; they are aggregates of service potentials available for, or beneficial to expected operations." The notion of "service potentials" provides a sound conceptual basis for asset valuation. Rarely, however, can the economic value (the discounted value of future cash flows) of service potentials be measured in ways that meet the test of verifiable evidence stated previously. Predicting cash flows and allocating them to individual assets in the typical situation where cash flows are the result of the joint use of many assets present insurmountable difficulties." (7)

Instead of discounting the estimated future cash flows of assets, we recommended that specific current market prices (replacement-cost valuation) of similar assets be used for asset valuations. If any asset is no longer available in the market place, then a specific index must be used to restate its net value.

The notion that measurements of income and other financial data may possess greater utility when expressed in current terms has long been supported by accountants, principally academicians, especially in recent years.⁸

Current costs (replacement-cost valuation) can be advocated on the following grounds:

- (i) The current cost represents the amount the firm would have to pay today to obtain the asset or its services; therefore, it represents the best measure of the value of the inputs being matched against current revenues for predictive purposes.
- (ii) This matching of current costs against current revenues permits the separation of gains and losses from the holding of assets and the recognition of profit and loss from operations. This permits a proper appraisal of managerial effectiveness.
- (iii) The current cost represents the value of the asset to the firm if the firm is continuing to acquire such assets and if value has not been added by the enterprise to the asset.
- (iv) The summation of assets expressed in current terms is more meaningful than the addition of historical costs incurred at different time periods. Data expressed in current cost terms are more readily comparable between entities.

Gynther in his book *Accounting for Price-Level Changes Theory and Procedures* says:

"The use of specific current market prices or specific indexes will give values as close to values which discount future net benefits to the present as one can obtain in practice. The discounting is carried out in the market place and reflects approximately the expectations of all firms operating there at any time. But it does not reflect the expectations of the individual firm which is not operating in the market place at that point of time, and therefore does not necessarily reflect the value of an asset to a firm which purchased an asset sometime previously. However, any estimated differences between such current market valuations (after allowing for depreciation) and the net value of an asset to a firm can be accounted for." (9)

Dwight R. Iadd seems to support much of the above.

He says:

"Replacement cost seems to be a generally substitute for present value on fixed-asset accounting. It is certainly a vast improvement over historical cost which in many cases will not even closely approximate the current value of future service potential.....Replacement cost is far more in keeping with the contemporary view of the corporation as an on-going instrument for the production of goods and services. The importance of such an instrument lies in its capacity to produce both at present and on into the future, and a meaningful statement of the value of productive capacity it currently holds must express the cost of maintaining it." (10)

The American Accounting Association's Committee on Concepts and Standards - Long-Lived Assets said this:

"Service potential is the essential element in asset valuation. Where measurements of current service potential in terms of discounted cash flows can be supported by sufficient objective evidence, as in the case of most long-term receivables and payables, they are generally used. Whenever sufficient objective evidence is not available, or when cash flow estimates cannot be identified with specific assets, a practical approximate measurement of service potential may be attained by reference to the current cost of securing the same or equivalent services....."

Where there is an established market for assets of like kind and condition, quoted prices provide the most objective evidence of current cost. Such prices may be readily available for land, buildings and certain types of standard equipment. Where there is no established market for assets of like kind and condition, current cost may be estimated by reference to the purchase price of assets which provide equivalent service capacity. The purchase price of such substitute assets should be adjusted for differences in operating characteristics such as cost, capacity, and quality. In other cases, adjustment of historical cost by the use of specific price indexes may provide acceptable approximations of current cost. Appraisals are acceptable only if they are based on the above methods of estimating current cost." (11)

The majority of members of the American Accounting Association's Committee on Concepts and Standards - Inventory Measurement "maintain that replacement cost is the best of several available inventory measurements" and that "replacement costs should be regarded as the primary basis of inventory measurement."¹²

To conclude, historic cost data do not measure wealth or profit satisfactorily. The increase in present value of the firm during a period, after adjusting for ownership contributions/distributions during the period, provides a conceptual ideal for the increase in the firm's net resources. Such profit, often called increased net worth or subjective profit, could not be measured with any degree of objectivity. A corresponding measure based on the replacement cost of resources becomes appropriate for reasons previously advanced in relation to value,¹³ and subject to the same limitations.

The measurement of profit on a replacement cost basis can be approached by two alternative methods.

Net resources at one date can be deducted from net resources valued at a later date and the residue adjusted for ownership contributions/distributions to give profit or loss. This approach requires the valuation of all assets and liabilities of the firm at just two dates, the beginning and end of the accounting period. Thus a profit calculation could be obtained by valuing at replacement cost at the balance sheet date without considering the transactions which occurred during the year.

Alternatively activities can be recorded on the chosen valuation basis as they occur during the year, any amendments could be made to value as changes occurred during the year, and profit/

loss calculated at the end of the year. This is the normal accounting approach, although with a replacement-cost valuation basis. The final residual profit would be the same as before, but it is possible to analyze the composition of profit.

In view of all the objections to historical cost, it may seem surprising that so little progress has been made in the direction of improving the quality of financial information either by adding or substituting more relevant figures to those produced by the historical cost concept.

The reasons however are not far to seek. Many accountants feel safer with historical-costs because they believe they are more objective than any alternative. And they also feel reassured by the fact that in times of rising prices historical cost balance sheets are more conservative. (This is to ignore the fact that the income statements are less conservative).

There are other weighty reasons. The accounting profession feels, reasonably, that it cannot abandon historical cost if the abandonment would not be recognised in law. And it is a fact that tax law and practice, legal definitions of capital and amounts available for dividends, trust deeds, contracts and many other statutory and common law instruments are enacted or negotiated on the basis of historical cost, on the assumption that the value of the monetary unit is stable. For these reasons alone, we must accept that any changes made by accountants must

be additional to rather than in substitution of historical cost statements, at least for the foreseeable future. At the same time, it is obviously hopeless to expect the taxation authorities to recognise any other basis of income determination if accountants themselves stick so emphatically to historical cost.

Many accountants even question the usefulness of the above proposal because estimates of current value, however defined, lack objectivity. However, when assets increase significantly in value, it may be useful to provide fair-value (current value) information in supplementary form despite the absence of precision and objectivity inherent in such information. It is probably safe to conclude that financial reporting would be improved if more relevant information were made available to users even by sacrificing some precision and objectivity. In 1973, the Study Group on Objectives of Financial Statements headed by Robert H. Trueblood recommended that "current values should also be reported when they differ significantly from historical cost."¹⁴ This issue will probably continue to receive considerable attention in the years ahead.

Types of Financial Statements: The individual statements that would be necessary for the fulfillment of the overall purpose of financial statements are a balance sheet, a statement of income and a statement of financial activities. These statements

generally need to be presented together not only to satisfy the overall purpose of financial statements but to achieve the purpose of the individual statements as well. For example, a thorough evaluation of the financial strength of a business at a given date cannot be achieved by a study of only the balance sheet. Much relevant information on productivity, on the efficiency with which economic resources are used and on liquidity and debt-paying ability is provided by the statement of income and the statement of financial activities when these statements are read in conjunction with the balance sheet.

6.5.3. Conclusion

A secondary purpose of the thesis was to outline an alternative measure of profit to that currently offered in financial reports. This we tried to do so in chapter five of the thesis and in part of this chapter we set forth some objectives of financial statements and tried to show that the acceptance of these objectives meant that we should follow the value approach in financial reporting. In other words, accepting the objectives meant that there should be a basic change in attitude that will acknowledge value as a goal so that cost will be regarded as a means of conveying information about value, rather than being viewed as an end or objective in itself.

The alternative measure of profit and asset valuation which we developed in chapter five of the thesis was based on

the economic concepts of value and income. The objectives of financial statements we set forth in part of this chapter pointed towards the value approach in financial reporting. As such we can say that there is a close relationship between the alternative measure of profit and asset valuation which we developed in chapter five of the thesis, and the objectives of financial statements set forth in part of this chapter. Alternatively, we can say that taking the objectives of financial statements into consideration, our alternative measure of profit and asset valuation is supported by these objectives and in turn tries to accomplish these objectives effectively.

In fulfilling our secondary purpose of the thesis, we had been dealing with an area of what academics generally describe as accounting theory. It is an area which is growing in importance, and it is certainly very much important today than it was even twenty five years ago or twenty years ago.

"It is a truism that the more one learns the more one realizes how much more there is still to be learnt, but it is a truism which I think applies with especial force to the modern accountant. I would certainly be the last to suggest that we will find all our answers from studying and developing accounting theory. In fact, as I hope I have been able to demonstrate, the role of accounting theory is not so much to provide answers as to make sure that we ask all the right questions. It is only experience that will finally give us the answers." (15)

APPENDIXSIMBA TOURS AND LODGES LIMITED: A CASE STUDY¹

On the morning of April 8, 1973, Mr. Shiraz Mohamed appeared at the office of Pannell Bellhouse Mwangi and Company, auditors and accountants. Mohamed was disturbed, as he handed a cutting from the "DAILY NEWS" to Peter Copp, the resident manager of Pannell Bellhouse Mwangi and Company. Copp, who had just reviewed the audit working paper file and the drafts accounts of Simba Tours and Lodges Limited, prepared by his assistant Salim Hecraj, went over the cutting with concern.

The cutting that Mohamed handed to Muir read:

TANZANIA TOURS TO HANDLEALL CRATER TOURISTS

Tanzania Tours Limited will from next month be the sole operators of Land Rover Tourists vans in the Ngorongoro Crater, the General Manager of the Tanzania Tourist Corporation, Mr. G.M.S. Mswalla announced in Dar es Salaam yesterday.

To carry out the work successfully, the company, a subsidiary of the Tanzania Tourist Corporation, will increase its present fleet of Land Rover of 53 vans by 30 vans which have already been ordered. The vans are expected to arrive soon.

Mr. Mswalla also disclosed other plans for the hotel industry as far as his corporation was concerned. These include the take over of some hotels and lodges in the Northern Tourist Circuit by 1974 and improvement of the services by giving refresher courses to hotel staff at the school in Dar es Salaam.

"Existing management and marketing contracts are not being renewed" he said adding that:

"while some expatriates will be engaged for the next few years, a considerable number of senior management positions will be filled by fully trained Tansanians."

"DAILY NEWS: 8.5.73"

Mr. Mohamed is one of the Directors of Simba Tours and Lodges Limited. Simba Tours and Lodges Limited, a private company, was incorporated on 8th August, 1962. The main objects for which the company was established were:

- (1) to carry on the business of hotel, restaurant, cafe, road house auto-court, motel and safari and holiday camp keepers;
- (2) to acquire, erect, alter and furnish any property for the purpose of letting to visitors or guests whether in single room suites, chalets, cottages or otherwise.

At present, the company carries on the business as tour operators by transporting their visitors in the Ngorongoro area, one of the world's largest single wildlife spots. The company also operates lodges in the Ngorongoro area, which provide accommodation and food to the tourists.

The people holding shares in the company are all foreigners. Given below is a list of persons holding shares in Simba Tours and Lodges Limited:

LIST OF PERSONS HOLDING SHARES IN STL LIMITED

<u>Name of Shareholder</u>	<u>Number of Shares held</u>	<u>Nationality</u>
Rose Bell Carmichael	36,000	American
Arthur Reginald Armitage	22,500	British
John Sherry Wallace	8,000	American
Hary Bill Carmichael (Jnr.)	13,500	American
	<u>80,000</u>	

The shareholders of Simba Tours and Lodges Limited are also the shareholders of Jambo Jambo Lodge Limited, an associated company of Simba Tours and Lodges Limited. The above associated company runs on the same lines as Simba Tours and Lodges Limited.

In early 1972, the government of Tanzania worried about the amount of foreign exchange flowing out of the country in the form of Dividends, passed the COMPANIES (REGULATION OF DIVIDENDS AND SURPLUSES AND MISCELLANEOUS PROVISIONS) ACT, 1972.

Section 7(1) of the Act concerning "Limitation on Dividends" is quoted below:

"No company, whether or not a specified company, shall, in respect of any financial year, declare dividends the aggregate sum of money payable in respect of which-

- (a) exceeds the sum of money which when deducted from the company's net worth in respect of such financial year will have the effect of reducing such net worth to a sum of money which is less than one hundred and twenty five per centum of the par value of the company's paid up share capital at the close of such financial year; OR
- (b) exceeds the largest of the following sums of money, namely -
 - (i) the average of the annual profits of such company, during the 3 financial years immediately preceding such financial year; OR
 - (ii) eighty per centum of the profits in the financial year immediately preceding such financial year; OR
 - (iii) where the company first commenced its business immediately before or during such financial year, eighty per centum of its profits in such financial year. "

In August 1972, the government of Tanzania passed the SPECIFIED COMPANIES (FURTHER LIMITATION ON DIVIDENDS) ORDER.

The order read:

April 1973, 1973

"No specified company shall declare dividends in respect of the current financial year or any subsequent financial year, the aggregate of which exceeds twenty per centum of such company's approved net worth."

Simba Tours and Lodges Limited was made a specified company under the above order.

Mr. Copp called in his assistant and asked him to stop all work on the accounts of Simba Tours and Lodges Limited till they hear from Mrs. Rose Bell Carmichael, one of the principal shareholders and directors, residing in America, lest she has something to say concerning some changes in the accounts, now that there was the worry of the possible future takeover of Simba Tours and Lodges Limited by a parastatal organisation, the Tanzania Tours Limited.

On April 22, 1973, there was a letter from Mrs. Rose Bell Carmichael, awaiting Mr. Copp's attention. The letter read:

(1) ...

Rose Bell Carnichael
 4026-29th Street
 Des Moines, Iowa 50310

April 17th, 1973

Mr. P. Copp,
 P.B.M & Co.,
 Box 180,
 Arusha,
 Tanzania.

Dear Peter,

Please be advised that we have of recent received a letter from Mr. Mawalla, Manager of Tanzania Tourist Corporation, informing us to open formal discussions for Tanzania Tourist Corporation's participation in Simba Tours and Lodges Limited, as shareholders.

It was stressed that unless a local parastatal organisation participated in the capital of the company, the government would be reluctant to renew the lease and Right of Occupancy of Simba Tours and Lodges Limited, which expires in 1974. You can get a copy of this letter from our Arusha office.

We would like to have some advice from you concerning the following matters:

- (1) Bearing in mind that the company may be nationalised or subject to Tanzania Tourist Corporation participation, we feel it is desirable to absorb as much

as possible of the retained profits. To this end, we would like Simba Tours and Lodges Limited to declare as much of the retained profits as dividends.

(2) The second problem concerns the amount due to the Associated Company in the amount of shillings 2,511,386/-. that Jambo Jambo Lodge Limited owes Simba Tours and Lodges Limited. We are worried that if the Tanzania Tourist Corporation becomes involved in Simba Tours and Lodges Limited, they will then exercise control over Jambo Jambo Lodge Limited by reason of the huge debt owing to Simba Tours and Lodges Limited. As such it is desirable that this amount be eliminated from the Simba Tours and Lodges Limited accounts in order to avoid indirect government control over Jambo Jambo Lodge Limited.

Since both companies have the same shareholders, which way would be more proper to handle this matter?

(i) Simba Tours and Lodges Limited to declare this amount a Dividend, to be payable when funds are available,

OR

(ii) Prepare a note payable to each shareholder.

We would appreciate your decision about these matters and if you should need the advice from an advocate, please feel free to do so.

Have the proper document drawn up and send to me as quickly as possible.

Thankyou,

Yours sincerely,

R.B.C.
Chairman

Copp, being an expert on such matters, knew that part of the contents of the letter was rubbish. It was not so simple as Mrs. Carmichael has asked them to do. But, Copp being a reasonable man, gave due consideration to the contents of the letter from Mrs. Carmichael. He called in his assistant and asked him to provide him with the audited accounts for the years 1969, 1970 and 1971 and the Draft Accounts for the year 1972 for Simba Tours and Lodges Limited. He also asked him to provide the Draft Accounts for the year 1972, for Jambo Jambo Lodge Limited. These financial statements are shown in Exhibits 1, 2, 3, 4, and 5, respectively.

Copp and his assistant Salia Hearsj² went to work on the issues, evaluating the ideas presented by Mrs. Carmichael

in her letter and at the same time trying to come up with some better generally accepted alternatives.

In finding out an acceptable solution, attention was directed to the following three areas:

- (a) Evaluation of the solution as suggested by Mrs. Carmichael in problem 1.
- (b) Finding other generally accepted alternatives to deal with the 2 problems raised by Mrs. Carmichael in her letter. These alternatives were to be the best ways of dealing with these issues.
- (c) Finding out a reasonable solution if the shareholders of Simba Tours and Lodges Limited were not interested in selling a portion of their shareholding in any merger terms which would require them to relinquish direct management of their company.

SINRA TOURS AND LODGES LIMITED

BALANCE SHEET AS AT 31ST MAY, 1969.

<u>1968</u> Tz. Shs.			
	<u>FIXED ASSETS:</u>		
537,190	At Cost less Depreciation per attached Summary		672,978.00
	<u>GOODWILL:</u>		
100,000	At Cost less written off		100,000.00
	<u>ASSOCIATED COMPANY:</u>		
-	Jambo Jambo Lodge Limited		37,278.20
<u>637,190</u>			<u>810,256.20</u>
	<u>CURRENT ASSETS:</u>		
136,338	Stocks at Cost or Valuation	240,038.60	
304,140	Sundry Debtors and Prepayments	383,048.85	
155,811	Fire Insurance Claim	-	
-	Fixed Deposit	500,000.00	
645,158	Cash at Bank	220,647.20	
23,774	Cash on Hand and Float	22,003.10	
<u>1,265,221</u>		<u>1,365,737.75</u>	
	<u>Deduct:</u>		
	<u>CURRENT LIABILITIES:</u>		
211,683	Sundry Creditors and Accrued Charges	287,715.40	
188,418	Deposits from Customers	248,045.90	
253,152	Corporation Tax: 1968	349,792.00	
352,000	1969	402,048.00	
151,410	Directors' Current Accounts	18,794.10	
<u>1,156,663</u>		<u>1,312,395.40</u>	
103,558			53,342.35
<u>745,748</u>			<u>Tz. Shs. 863,542.55</u>

SIMBA TOURS AND LODGES LIMITED

BALANCE SHEET AS AT 31ST MAY, 1968

1968
Ts. Shs.REPRESENTED BY:

	<u>SHARE CAPITAL:</u>	<u>Authorised</u>	<u>Issued</u>
<u>320,000</u>	17,000 Shares of Ts.Shs.20/-each	<u>340,000.00</u>	
320,000	16,000 Shares of Ts.Shs.20/-each Fully Paid		320,000.00
	<u>REVENUE RESERVE:</u>		
425,748	Profit and Loss Appropriation Account		543,598.55
<u>745,748</u>		Ts. Shs.	<u>863,598.55</u>

NOTE:

The following contingent liabilities exist at the Balance Sheet date:

- (a) Severance Allowances which may become payable to certain employees when they cease to be employed.
- (b) Surety Bond of Shs.4,000 given to Immigration Department.

.....DIRECTOR.

.....DIRECTOR.

REPORT OF THE AUDITORS TO THE MEMBERS
SIMBA TOURS AND LODGES LIMITED

We have audited the above Balance Sheet. We have not been able to reconcile the deposits from customers. With this reservation we have obtained all the information and explanations we have required. In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs according to the best of our information and the explanations given to us and as shown by the books of the Company.

ARUSHA:Chartered Accountants.

PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED
31ST MAY, 1969

1968 Tz. Shs.			
169,459	Balance Brought Forward		425,747.90
849,889	Profit for the Year		1,003,690.65
12,000	Over Provision for Taxation in previous Year		2,208.00
<u>1,031,348</u>			<u>1,431,646.55</u>
	<u>Deduct:</u>		
352,000	Provision for Corporation Tax - 1969	403,048.00	
253,600	Dividend paid out of profits for the year to 31st May, 1968	480,000.00	
605,600			888,048.00
<u>425,748</u>	Balance Carried Forward		<u>Tz. Shs. 543,598.55</u>
	Electricity and Heating Expenses	31,000.00	
	Water	12,000.00	
	Local Post	22,000.00	
	Clothing, Glasses and Shoes	40,000.00	
<u>105,000</u>			<u>105,000.00</u>
	General Vehicle Operating Expenses	25,000.00	
	Traveling Expenses of Directors	75,000.00	
	Traveling Expenses of Staff	2,000.00	
	Radio and Telephone Expenses	10,000.00	
	Postage and Telegrams	5,000.00	
<u>75,000</u>			<u>75,000.00</u>
	Interest	-	
	Depreciation - Furniture, Equipment and	200,000.00	
	Plant	10,000.00	
	Motor Vehicle Expenses	10,000.00	
	Public Relations Expenses	-	
	Advertising	1,000.00	
	Insurance	20,000.00	
	Entertainment and Refreshments	2,000.00	
	Carriage, Freight and Dock	10,000.00	
	Salaries	10,000.00	
	Bad Debt	100.00	
	Staff Entertainment Expenses	45.00	
	Legal and Professional Fees	-	
	Gifts and Amusement Fees	10,000.00	
<u>425,748</u>	Carried Forward		<u>425,748.00</u>

SIMBA TOURS AND LODGES LIMITED

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1969.

<u>1968</u>			
Ts. Shs.			
Gross Profit per Trading Account:			
1,144,956	Accommodation	1,404,846.35	
247,173	Dining Room	289,895.70	
96,974	Bar	111,109.65	
5,867	Cigarettes	5,136.80	
93,925	Shop	70,149.25	
192,314	Land Rover Hire and Workshop	277,513.20	
12,755	Petrol Service Stations	6,455.05	
<hr/>			
1,793,964	Sundry Revenue	2,164,106.00	
2,110	Cancellation Fees	2,060.55	
220,864	Profit on Exchange less Bank Charges	249,540.00	
3,424	Profit on Sale of Assets	2,777.85	
-		32,000.00	
<hr/>			
<u>2,020,362</u>		Ts. Shs.	<u>2,450,484.40</u>
<hr/>			
137,828	Salaries and Commissions	117,062.00	
33,900	Managing Director's Salary	51,600.00	
53,456	Managing Director's Commission	77,341.00	
123,988	Maintenance and General Wages	148,322.50	
	Staff Accommodation and		
43,200	Food Expenses	84,000.00	
<hr/>			
<u>392,372</u>			<u>478,325.50</u>
<hr/>			
43,553	General Repairs and Renewals	69,934.75	
18,303	Electric Plant Running Expenses	31,043.25	
13,645	Water	13,315.95	
24,000	Land Rent	24,000.00	
38,074	Crockery, Glassware and Linen	49,833.80	
<hr/>			
<u>137,575</u>			<u>188,127.75</u>
<hr/>			
8,321	General Vehicle Running Expenses	29,691.75	
28,829	Travelling Expenses - Directors	76,234.90	
23,311	Travelling Expenses - Staff	2,918.60	
8,607	Radio and Telephone Expenses	12,535.90	
6,810	Postages and Telegrams	8,964.65	
<hr/>			
<u>75,878</u>			<u>130,345.80</u>
<hr/>			
429	Interest	-	
178,846	Travel Agents' Commission and	240,852.80	
5,912	Discount	12,955.00	
6,168	Entertaining Expenses	-	
13,424	Sales Promotion Programme	3,392.00	
23,175	Advertising	44,104.50	
826	Insurance	2,243.00	
926	Subscriptions and Donations	1,826.95	
8,680	Newspapers, Magazines and Books	10,120.00	
-	Licences	300.50	
-	Bad Debts	45.50	
3,485	Debt Collection Charges	-	
14,500	Legal and Professional Fees	14,000.00	
-	Audit and Accountancy Fees	23,182.35	
-	National Provident Fund Contribution	-	
<hr/>			
<u>256,371</u>			<u>353,027.10</u>
<hr/>			
	Carried Forward		<u>1,149,821.15</u>

SINBA TOURS AND LODGES LIMITED

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31st MAY, 1969.

1968		1969	
Tz. Shs.		Tz. Shs.	
Sales		1,019,425.53	
Stock - 1st June, 1968		13,248.00	
Brought Forward		367,404.20	
		301,052.70	
6,000	Arusha Office Rent	6,900.00	
20,699	Uniforms	26,351.60	
3,128	Medical Expenses	12,082.75	
2,741	Office Expenses	5,217.85	
7,341	General Expenses	4,242.15	
20,895	Stationery	26,860.70	
2,997	Loss on Sale of Fixed Assets	-	
	Loss on Fixed Assets destroyed	-	
248	by Fire	-	
128,313	Depreciation for the Year	215,317.55	
<hr/>		<hr/>	
192,362		165,957.50	296,972.60
		<hr/>	
		1,446,793.75	
		<hr/>	
115,916	Cash defalcations by employee	-	
<hr/>		<hr/>	
849,888	Net Profit before Taxation	73,840.50	1,003,690.65
<hr/>		<hr/>	
2,020,362	1st May, 1969	2,500,494.10	2,450,434.40
<hr/>		<hr/>	
Trading Profit		2,373,014.10	
<hr/>		<hr/>	
Expenses			
	Wages	21,111.10	
	Fuel	61,011.89	
	Transport	24,324.60	
		106,447.59	
		<hr/>	
		2,404,216.35	
		<hr/>	
		106,277.40	
Stock - 1st June, 1968		25,204.10	
Brought Forward		147,091.10	
		172,295.40	
		<hr/>	
		135,400.70	
Stock - 1st May, 1969		71,897.00	
		156,774.00	
<hr/>		<hr/>	
Trading Profit		14,500.00	
<hr/>		<hr/>	
Expenses			
	Wages	10,991.40	
	Transport	4,220.50	
		15,211.90	
		<hr/>	
		131,562.10	
		<hr/>	
		1,404,054.70	

SIMBA TOURS AND LODGES LIMITED

TRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1969

DINING ROOM

Sales		1,019,425.55	
Stock - 1st June, 1968	13,648.00		
Purchases	<u>567,404.20</u>		
		581,052.20	
		<u>438,373.35</u>	
Stock - 31st May, 1969		15,520.25	
Trading Profit		453,893.60	
<u>Deduct:</u>			
Wages	110,860.70		
Fuel	27,536.55		
Transport	16,476.45		
Firewood	<u>10,124.20</u>		
		164,997.90	
			288,895.70

ACCOMMODATION

Sales		1,641,334.60	
Stock - 1st June, 1968	5,250.00		
Purchases	<u>66,590.50</u>		
		71,840.50	
		<u>1,569,494.10</u>	
Stock - 31st May, 1969		4,000.00	
Trading Profit		1,573,494.10	
<u>Deduct:</u>			
Wages	83,111.30		
Fuel	61,011.85		
Transport	<u>24,524.60</u>		
		168,647.75	
			1,404,846.35

BAR

Sales		306,297.60	
Stock - 1st June, 1968	25,206.10		
Purchases	<u>147,691.30</u>		
		172,897.40	
		<u>133,400.20</u>	
Stock - 31st May, 1969		23,391.80	
Trading Profit		156,792.00	
<u>Deduct:</u>			
Wages	40,691.45		
Transport	<u>4,990.90</u>		
		45,682.35	
			111,109.65
Carried Forward			<u>1,804,851.70</u>

SIMBA TOURS AND LODGES LIMITED

TRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1969.

Brought Forward 1,804,851.70

CIGARETTES

Sales		38,434.95	
Stock - 1st June, 1968	811.80		
Purchases	36,460.45		
		<u>37,272.25</u>	
		1,162.70	
Stock - 31st May, 1969		<u>3,974.10</u>	
Trading Profit		<u>5,136.80</u>	5,136.80

S H O P

Sales		430,567.80	
Stock - 1st June, 1968	43,772.00		
Purchases	437,711.25		
		<u>481,483.25</u>	
		(50,915.45)	
Stock - 31st May, 1969		<u>121,064.70</u>	
Trading Profit		<u>70,149.25</u>	70,149.25

PETROL SERVICE STATION

Sales		332,308.25	
Stock - 1st June, 1968	29,576.35		
Purchases	328,324.00		
		<u>337,900.35</u>	
		(5,592.10)	
Stock - 31st May, 1969		<u>17,253.95</u>	
Trading Profit		<u>11,661.85</u>	
<u>Deduct: Wages</u>		<u>5,206.80</u>	6,455.05

LANDROVER HIRE AND WORKSHOP SALES

Sales		624,946.15	
<u>Deduct:</u>			
Wages	58,475.45		
Repairs	147,107.50		
Petrol and Oil	82,627.65		
Permits to Grater	9,210.00		
Workshop Expenses	50,012.35		
		<u>347,432.95</u>	
			<u>277,513.20</u>
Gross Profit carried to Profit and Loss Account		Tr. Acc.	2,164,106.00

SUMMARY OF FIXED ASSETS FOR THE YEAR ENDED 31ST MAY, 1969.

	<u>C</u>	<u>O</u>	<u>S</u>	<u>T</u>	<u>D</u>	<u>E</u>	<u>P</u>	<u>R</u>	<u>E</u>	<u>C</u>	<u>I</u>	<u>A</u>	<u>T</u>	<u>I</u>	<u>O</u>	<u>N</u>
	<u>1.6.68</u>	<u>Additions</u>	<u>Sales</u>	<u>To</u>	<u>To</u>	<u>Adjustment</u>	<u>Charged to</u>	<u>on Disposal</u>	<u>P & L A/S</u>	<u>Accumulated</u>	<u>to 31.5.69</u>	<u>Net</u>				
<u>BUILDINGS</u>	606,438.09	101,448.05		707,886.14	287,252.09				70,788.05	358,040.14	349,846.00					
<u>TRACTORS</u>	23,209.00			23,209.00	23,208.00				-	23,208.00	1.00					
<u>MOTOR VEHICLES</u>	307,525.35	185,565.00	63,000.00	430,090.35	133,871.35	87,500.00	107,522.00			241,393.35	188,697.00					
<u>MACHINERY AND EQUIPMENT</u>	159,646.05	32,515.00		192,161.05	66,435.05				24,020.00	90,455.05	101,706.00					
<u>WORKSHOP EQUIPMENT</u>	27,944.95	425.00		28,369.95	17,705.95				3,546.00	21,251.95	7,118.00					
<u>FURNITURE AND FITTINGS:</u>	68,882.33	6,652.50		75,534.83	40,483.33				9,441.50	49,924.83	25,610.00					
Ts. Shs.	1,193,645.77	326,605.55	63,000.00	1,457,251.32	568,955.77	87,500.00	215,317.55			784,273.32	672,978.00					

SALE OF MOTOR VEHICLES:

	<u>AR 8301</u>	<u>ARA 919</u>	<u>AR 8302</u>
Cost as at 1st July, 1968	28,000.00	7,000.00	28,000.00
Accumulated Depreciation	42,000.00	3,500.00	42,000.00
	(14,000.00)	3,500.00	(14,000.00)
Sale Proceeds	1,500.00	4,000.00	2,000.00
Profit on Sale of Assets	Ts. Shs. 15,500.00	(500.00)	(16,000.00)

SINDA TOURS AND LODGES LIMITED
BALANCE SHEET AS AT 31ST MAY, 1970

EXHIBIT 2

1969
Tz. Shs.

FIXED ASSETS:

672,978	At Cost less Depreciation per attached Summary	626,963.00
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GOOD WILL:

100,000	At Cost less Written Off	100,000.00
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ASSOCIATED COMPANY:

37,278	Jambe Jambe Lodge Limited	1,139,524.00
<u>810,256</u>		<u>1,866,487.00</u>

CURRENT ASSETS:

235,038	Stocks at Cost or Valuation	259,730.65
	Estimated Stock of Stationery and Crater Entry Permits	6,500.00
5,000	Debtors and Prepayments	160,802.15
	Less: Provision for Bad and Doubtful Debts	<u>5,819.00</u>
358,301		154,983.15
24,748	Loans to Staff	23,990.05
500,000	Fixed Deposit	-
-	Corporation Tax Recoverable	8,112.00
-	Directors' Current Accounts	40,719.45
220,647	Cash at Bank	161,498.10
22,003	Cash in Hand and Float	<u>30,740.85</u>
<u>1,365,737</u>		<u>686,274.25</u>

Deduct:

CURRENT LIABILITIES:

287,715	Creditors and Accrued Charges	309,559.80
248,046	Deposits from Customers	48,450.00
349,792	Corporation Tax - 1968	-
408,048	1969	-
-	1970	566,528.00
-	Proposed Dividend year to 31st May, 1969	400,000.00
-	Proposed Dividend year to 31st May, 1970	600,000.00
18,794	Directors' Current Accounts	-
<u>1,312,395</u>		<u>1,924,537.80</u>

53,342	<u>NET CURRENT ASSETS(LIABILITIES)</u>	(1,238,263.55)
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<u>863,598</u>	<u>NET ASSETS, Representing Shareholders' Interest</u>	<u>Tz. Shs. 628,223.45</u>
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Shareholders' Interest:

SHARE CAPITAL

		<u>Authorised</u>	<u>Issued and Fully Paid</u>
<u>340,000</u>	17,000 Shares of Tz. Shs. 20/= each	<u>340,000.00</u>	
<u>320,000</u>	16,000 Shares of Tz. Shs. 20/= each		<u>320,000.00</u>

REVENUE RESERVE:

543,598	Profit and Loss Appropriation Account	308,223.45
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863,598	The attached Notes form an integral part of this Balance Sheet.	Tz. Shs. <u>628,223.45</u>
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.....Director.
Director.

This is the Balance Sheet referred to in our report of even date.

ARUSHA: 2 SEP 1969

Chartered Accountants.

SIMBA TOURS AND LODGES LIMITED

PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1970

	General Profit and Trading Accounts		
	Accountants' Fees		2,499,731.15
	Printing Expenses		308,227.00
	Depreciation		97,400.30
	Bad Debts		100.00
	Loss on Sale of Assets		451,000.00
	Loss on Sale of Stocks		100.00
	Interest on Bank Deposits		20,000.00
	Income Tax		2,791,530.00
1969			
Tz. Shs.			
425,748	Balance Brought Forward		543,598.55
1,003,690	Profit for the Year		1,331,152.90
1,429,438			1,874,751.45
2,208	Overprovision for Taxation in previous Years		100.15
1,431,646			1,874,851.60
	Deduct:		
408,048	Provision for Corporation Tax - 1970	566,528.00	
480,000	Dividends:		
-	Paid - Year to 31st May, 1968	-	
-	Proposed - Year to 31st May, 1969	400,000.00	
-	Year to 31st May, 1970	600,000.00	
898,048			1,566,528.00
543,598	Balance Carried Forward		Tz. Shs. 308,223.45
180,127			179,108.00
37,871	General Expenses and Transfers		
25,727	General Expenses	25,727.00	
1,144	Traveling Expenses & Directors' Fees	20,724.00	
17,146	Auditors and Taxation Expenses	25,574.00	
4,000	Postages and Telegrams	10,479.00	
179,265			94,871.15
242,863	Travel Agents' Commission and Disbursements	242,863.00	
8,400	Entertaining Expenses - Directors' Staff	17,420.00	
8,800		3,800.00	
3,200	Advertising	2,526.00	
40,174	Insurance	20,321.00	
2,000	Subscriptions and Donations	2,000.00	
3,000	Repairs, Repainting and Sundries	2,025.25	
-	Bank Purchase Interest	3,125.00	
20,170	Interest	10,700.00	
500	Loss on Sale of Assets	500.00	
254,769	Residual Foreign	225,061.45	228,223.45

SIMBA TOURS AND LODGES LIMITED
PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1970

<u>1969</u>			
Tz. Shs.	Gross Profit per Trading Account:		
1,404,846	Accommodation		1,499,231.10
288,896	Dining Room		328,057.65
111,110	Bar		97,450.30
5,137	Cigarettes		4,749.50
70,149	Shop		142,157.75
277,513	Land Rover Hire and Workshop		451,081.45
6,455	Petrol Service Station		18,172.45
<hr/>			<hr/>
2,164,106			2,540,900.20
2,060	Sundry Revenue		881.00
249,540	Cancellation Fees		347,976.00
	Bad Debts Recovered		310.15
2,778	Profit on Exchange less Bank Charges		4,500.20
32,000	Profit on Sale of Assets		-
-	Interest on Fixed Deposit		26,689.25
<hr/>			<hr/>
2,450,484			2,921,336.80
<hr/>			
117,062	Salaries and Commissions	140,806.00	
51,600	Managing Director's Salary	51,600.00	
77,341	Managing Director's Commission	96,138.00	
148,322	Maintenance and General Wages	191,029.30	
	Staff Accommodation and		
84,000	Food Expenses	98,400.00	
<hr/>			
478,325			577,973.30
<hr/>			
69,935	General Repairs and		
	Renewals	56,979.25	
31,043	Electric Plant Running Expenses	32,320.60	
13,316	Water	20,360.30	
24,000	Land Rent	24,000.00	
49,833	Crockery, Glassware and Linen	45,497.85	
<hr/>			
188,127			179,158.00
<hr/>			
29,692	General Vehicles and Tractors		
	Running Expenses	22,656.20	
76,235	Travelling Expenses - Directors	38,724.05	
2,919	Staff	10,574.00	
12,536	Radion and Telephone Expenses	10,627.00	
8,964	Postages and Telegrams	12,295.90	
<hr/>			
130,346			94,877.15
<hr/>			
240,853	Travel Agents' Commission	249,007.05	
	and Discount		
8,626	Entertaining Expenses - Directors	17,832.80	
4,329	Staff	3,805.20	
3,392	Advertising	3,538.65	
44,104	Insurance	36,221.90	
2,243	Subscriptions and Donations	2,650.00	
1,827	Newspapers, Magazines and Books	2,025.35	
-	Hire Purchase Interest	3,120.00	
10,120	Licences	15,988.50	
301	Bad Debts Written Off	892.00	
<hr/>			
315,795	Carried Forward	335,081.45	852,008.45
			2,921,336.80

SIMBA TOURS AND LODGES LIMITED

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1970

1969
Tz. Shs.

315,795	Brought Forward	335,081.45	852,008.45	2,921,336.80
45	Debt Collection Charges	1,050.00		
-	Provision for Bad and :			
-	Doubtful Debts	5,819.00		
-	Legal and Professional Fees	840.00		
14,000	Audit and Accountancy Fees	14,000.00		
23,182	National Provident Fund Contributions	28,600.20		
<u>353,022</u>			<u>385,390.65</u>	
6,900	Arusha Office Rent	7,200.00		
26,352	Uniforms	27,000.30		
12,083	Medical Expenses	16,374.50		
5,218	Office Expenses	5,763.45		
4,242	General Expenses	3,589.00		
26,861	Stationery	35,954.45		
-	Loss on Sale of Fixed Assets	60.00		
215,318	Depreciation for the Year	256,843.10		
<u>296,974</u>			<u>352,784.80</u>	
1,446,794				1,590,183.90
<u>1,003,690</u>	Net Profit before Taxation		Tz. Shs.	<u>1,331,152.90</u>

SIMBA TOURS AND LODGES LIMITED

TRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1970

DINING ROOM

Sales		1,066,586.70
<u>Less: Stock as at 1st June, 1969</u>	15,520.25	
<u>Add: Purchases</u>	556,712.45	
	<u>572,232.70</u>	
<u>Less: Stock as at 31st May, 1970</u>	19,999.50	
Cost of Sales		<u>552,233.20</u>
		514,353.50
<u>Less: Direct Expenditure:</u>		
Wages	109,462.55	
Fuel	23,503.90	
Transport	8,619.40	
Firewood	44,710.00	
	<u>186,295.85</u>	
Gross Profit on Trading	Tz. Shs.	<u><u>328,057.65</u></u>

ACCOMMODATION

Sales		1,748,904.50
<u>Less: Stock as at 1st June, 1969</u>	4,000.00	
<u>Add: Purchases</u>	89,616.65	
	<u>92,616.65</u>	
<u>Less: Stock as at 31st May, 1970</u>	4,000.00	
Cost of Sales		<u>88,616.65</u>
		1,660,287.85
<u>Less: Direct Expenditure:</u>		
Wages	85,621.35	
Fuel	57,097.00	
Transport	18,338.40	
	<u>161,056.75</u>	
Gross Profit on Trading	Tz. Shs.	<u><u>1,499,231.10</u></u>

SIMBA TOURS AND LODGES LIMITED

TRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1970

B A R

Sales		345,196.90
<u>Less: Stock as at 1st June, 1969</u>	23,391.80	
<u>Add: Purchases</u>	211,915.70	
	<u>235,307.50</u>	
<u>Less: Stock as at 31st May, 1970</u>	34,638.30	
Cost of Sales		<u>200,669.20</u>
		144,527.70
<u>Less: Direct Expenditures:</u>		
Wages	43,390.75	
Transport	3,677.65	
	<u>47,077.40</u>	
Gross Profit on Trading		<u>Tz. Shs. 97,450.30</u>

CIGARETTES

Sales		44,204.95
<u>Less: Stock as at 1st June, 1969</u>	3,974.10	
<u>Add: Purchases</u>	38,055.65	
	<u>42,029.75</u>	
<u>Less: Stock as at 31st May, 1970</u>	2,574.30	
Cost of Sales		<u>39,455.45</u>
Gross Profit on Trading		<u>Tz. Shs. 4,749.50</u>

S H O P

Sales		546,007.70
<u>Less: Stock as at 1st June, 1969</u>	121,064.70	
<u>Add: Purchases</u>	435,806.00	
	<u>556,870.70</u>	
<u>Less: Stock as at 31st May, 1970</u>	153,020.75	
Cost of Sales		<u>403,849.95</u>
Gross Profit on Trading		<u>Tz. Shs. 142,157.75</u>

SIMBA TOURS AND LODGES LIMITED

TRADING ACCOUNT FOR THE YEAR ENDED 31st MAY 1970

PETROL SERVICE STATION.

Sales		209,519.65
Less:	Stock as at 1st June 1969	17,253.90
	Add: Purchases	<u>170,265.05</u>
		187,518.95
	Less: Stock as at 31st May 1970	<u>-</u>
		<u>187,518.95</u>
Cost of Sales		22,000.70
Less: Direct Expenditure		
	Wages	<u>3,828.25</u>
Gross profit on Trading	Tz. Shs.	<u><u>18,172.45</u></u>

LANDROVER HIRE AND WORKSHOP SALES.

Sales		860,489.65
Less:	Direct Expenditure	
	Wages	112,891.15
	Repairs	123,956.40
	Petrol and Oil	103,136.40
	Permits to Crater	58,280.00
	Workshop Expenses	<u>11,144.25</u>
		409,408.20
Gross Profit on Trading		<u><u>451,081.45</u></u>
Gross Profit Carried to Profit and Loss Account	Tz. Shs.	<u><u>2,540,900.20</u></u>

SIMPA TOURS AND LODGES LIMITED
SUMMARY OF FIXED ASSETS AS AT 31ST MAY, 1970

	C As at 1.6.69	D <u>Additions</u>	S <u>Sales</u>	T To 31.5.70	D E P To 31.5.69	R E C Adjustment on Disposal	I A T I Charged to P & L A/C	O N Accumulated Depreciation	Net
<u>BUILDINGS</u>	707,886.14	42,000.00		749,886.14	358,040.14		74,988.00	433,028.14	316,858.00
<u>TRACTORS</u>	23,209.00			23,209.00	23,208.00		-	23,208.00	1.00
<u>MOTOR VEHICLES</u>	430,090.35	130,013.00		560,103.35	241,393.35		140,025.00	381,418.35	178,685.00
<u>MACHINERY AND EQUIPMENT</u>	192,161.05	33,412.10	600.00	224,973.15	90,455.05	240.00	28,121.10	118,336.15	106,637.00
<u>WORKSHOP EQUIPMENT</u>	28,369.95	2,086.10		30,456.05	21,251.95		3,807.10	25,059.05	5,397.00
<u>FURNITURE AND FITTINGS</u>	75,534.83	3,845.90	169.00	79,211.73	49,924.83		9,901.90	59,826.73	19,385.00
Tz. She.	1,457,251.32	211,357.10	769.00	1,667,839.42	784,273.32	240.00	256,643.10	1,040,876.42	626,963.00

SALE OF TYPEWRITER

Cost as at 1st June, 1969	480.00
Less: Accumulated Depreciation	240.00
	<u>240.00</u>
Sale Proceeds	180.00
Loss on Sale to Profit and Loss Account	Shs 60.00

EXHIBIT 3SIMBA TOURS AND LODGES LIMITEDBALANCE SHEET . 31ST MAY, 1971

<u>1970</u> Shs.	<u>FIXED ASSETS:</u>	<u>Cost</u> Shs.	<u>Accumulated</u> <u>Depreciation</u> Shs.	<u>Shs.</u>
316,858	Buildings	749,886.14	509,016.14	241,870.00
178,686	Motor vehicles and tractors	567,312.35	532,651.35	34,661.00
112,034	Machinery and equipment	288,194.20	179,419.20	108,775.00
19,385	Furniture and fittings	81,147.73	69,969.73	11,178.00
<u>626,963</u>		<u>1,686,540.42</u>	<u>1,290,056.42</u>	<u>396,484.00</u>
	<u>GOOD WILL:</u>			
100,000	At cost less written off			100,000.00
	<u>ASSOCIATED COMPANY:</u>			
1,139,524	Jambo Jambo Lodge Limited			2,221,541.50
<u>1,866,487</u>				<u>2,718,025.50</u>
	<u>CURRENT ASSETS:</u>			
259,731	Stocks at cost and valuation		202,639.02	
6,500	Estimated stock of stationery and crater entry permits		-	
	Debtors and prepayments	412,481.55		
154,983	<u>Less: Provision for bad and doubtful debts</u>	<u>37,401.30</u>	375,080.25	
23,990	Loans to staff		4,650.00	
8,112	Corporation tax recoverable		-	
40,719	Directors' current accounts		109,318.50	
161,498	Cash at bank		97,813.30	
30,741	Cash in hand and float		11,489.70	
<u>686,274</u>			<u>800,990.77</u>	
	<u>Deduct:</u>			
	<u>CURRENT LIABILITIES:</u>			
309,560	Creditors and accrued charges	611,688.55		
48,450	Deposits from customers	13,905.00		
-	Current taxation	401,384.00		
566,528	Deferred taxation	424,896.00		
1,000,000	Proposed dividends	-		
<u>1,924,538</u>			<u>1,451,873.55</u>	
(1,238,264)				(650,882.78)
<u>628,223</u>				<u>Shs. 2,067,142.72</u>
	<u>Representing:</u>			
	<u>SHARE CAPITAL:</u>		<u>Authorised</u>	<u>Issued and Fully paid</u>
320,000	Shares of Shs.20/= each		340,000.00	320,000.00
	<u>REVENUE RESERVE:</u>			
308,223	Retained profit			1,747,142.72
<u>628,223</u>Director.		Shs.	<u>2,067,142.72</u>
Director.			

SIMBA TOURS AND LODGES LIMITED

PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1971

SIMBA TOURS AND LODGES LIMITED

		Shs.	
<u>PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1971</u>			
1,331,153	Profit for the year		848,415.27
After charging:			
256,843	Depreciation	257,180	
14,000	Audit and accountancy fees	14,000	
96,138	Directors remuneration	115,275	
51,766	Staff commission	32,993	
Proposed dividend written back			
-	Proposed dividend written back	1,000,000.00	1,000,000.00
1,331,153			1,848,415.27
<u>Deduct:</u>			
566,528	Provision for corporation tax	401,384.00	
-	Underprovision for corporation tax in previous years	8,112.00	
1,000,000	Proposed dividend	-	
1,566,528			409,496.00
(235,375)			1,438,919.27
543,598	Unappropriated profit - 1st June, 1970		308,223.45
308,223	<u>RETAINED PROFIT</u>		Shs. 1,747,142.72

SIMBA TOURS AND LODGES LIMITED
PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1971

<u>1970</u>			<u>Shs.</u>
	Gross profit per trading account:		Shs.
1,499,231	Accommodation		1,439,700.75
328,058	Dining room		90,178.25
97,450	Bar		169,951.93
4,750	Cigarettes		10,644.71
142,158	Shop		143,605.58
451,081	Land rover hire and workshop		450,805.80
18,172	Petrol service station		-
2,540,900	Sundry revenue		2,304,887.02
881	Cancellation fees		-
37,976	Bad debts recovered		249,152.00
310	Profit on exchange less bank charges		-
4,580	Interest on fixed deposit		9,039.70
26,689			-
2,921,336			2,563,078.72
140,806	Salaries and commissions	125,763.00	
51,600	Managing director's salary	54,000.00	
96,138	Managing director's commission	61,275.00	
191,029	Maintenance and general wages	214,686.55	
98,400	Staff accommodation and food expenses	98,400.00	
-	Staff transport	77,000.00	
577,973			631,124.55
56,979	General repairs and renewals	74,931.70	
32,321	Electric plant running expenses	36,508.80	
20,360	Water	23,389.70	
24,000	Land rent	24,000.00	
45,498	Crockery, glassware and linen	39,756.45	
179,158			198,586.65
22,656	General vehicles and tractors running expenses	1,900.05	
38,724	Travelling expenses - Directors	72,062.45	
10,574	Staff	24,811.50	
10,627	Radio and telephone expenses	16,421.05	
12,296	Postages and telegrams	11,031.95	
94,877			126,227.00
249,007	Travelling agents' commission and discount	233,492.65	
17,833	Entertaining expenses: Directors	14,105.70	
3,805	Staff	4,682.50	
3,539	Advertising	3,412.15	
36,222	Insurance	38,615.50	
2,650	Subscriptions and donations	770.00	
2,025	Newspapers, magazine and books	6,132.25	
3,120	Hire purchases interest	-	
15,988	Licences	11,573.35	
892	Bad debts written off	3,125.55	
335,081	Carried forward		955,938.20
			2,563,078.72

SIMBA TOURS AND LODGES LIMITED

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1971

1970 Shs.		Shs.	Shs.	Shs.
335,081	Brought forward	315,909.65	955,938.20	2,563,078.72
1,050	Debt collection charges	143.50		
5,819	Provision for bad and doubtful debts	31,582.30		
840	Legal and professional fees	1,739.00		
14,000	Audit and accountancy fees	14,000.00		
28,600	National Provident Fund contributions	17,336.60		
<u>385,390</u>			<u>380,711.05</u>	
7,200	Arusha office rent	9,900.00		
-	Rent tax	2,031.30		
27,000	Uniforms	26,164.95		
16,375	Medical expenses	1,892.65		
5,764	Office expenses	3,691.45		
3,589	General expenses	5,576.85		
35,954	Stationery	41,228.00		
60	Loss on sale of fixed assets	5,500.00		
256,843	Depreciation for the year	257,180.00		
-	Publications and promotional expenses	24,849.00		
<u>352,785</u>			<u>378,014.20</u>	
<u>1,590,183</u>				<u>1,714,663.45</u>
<u>1,331,153</u>	Net profit before taxation		Shs.	<u>848,415.27</u>

SIMBA TOURS AND LODGES LIMITED

TRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1971

	<u>DINING ROOM</u>	
		Shs.
Sales		991,007.85
<u>Less:</u>		
Stock - 1st June, 1970	19,999.50	
<u>Add:</u>		
Purchases	719,483.20	
	739,482.70	
<u>Less:</u>		
Stock - 31st May, 1971	43,571.50	
Cost of sales		<u>695,911.20</u>
		295,096.65
<u>Less:</u>		
<u>Direct expenditure:</u>		
Wages	129,947.75	
Fuel	21,428.25	
Transport	14,777.90	
Firewood	38,764.50	
		<u>204,918.40</u>
Gross profit on trading		Shs. <u>90,178.25</u>
	<u>ACCOMMODATION</u>	
Sales		1,670,985.05
<u>Less:</u>		
Stock - 1st June, 1970	4,000.00	
<u>Add:</u>		
Purchases	86,135.45	
	90,135.45	
<u>Less:</u>		
Stock - 31st May, 1971	4,000.00	
Cost of sales		<u>86,135.45</u>
		1,584,849.60
<u>Less:</u>		
<u>Direct expenditure:</u>		
Wages	81,943.05	
Fuel	49,968.80	
Transport	13,237.00	
		<u>145,148.85</u>
Gross profit on trading		Shs. <u>1,439,700.75</u>

SIMBA TOURS AND LODGES LIMITEDTRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1971

	<u>B A R</u>	Shs.	Shs.
Sales			480,850.00
<u>Less:</u>			
Stock - 1st June, 1970		34,638.30	
<u>Add:</u>			
Purchases		269,323.20	
		<u>303,961.50</u>	
<u>Less:</u>			
Stock - 31st May, 1971		49,710.33	
Cost of sales			<u>254,251.17</u>
			226,598.83
<u>Less:</u>			
<u>Direct expenditure:</u>			
Wages		52,818.60	
Transport		<u>3,828.30</u>	
			<u>56,646.90</u>
Gross profit on trading		Shs.	<u>169,951.93</u>

CIGARETTES

Sales		55,706.70	
<u>Less:</u>			
Stock - 1st June, 1970		2,574.30	
<u>Add:</u>			
Purchases		45,140.95	
		<u>47,715.25</u>	
<u>Less:</u>			
Stock - 31st May, 1971		2,653.26	
Cost of sales		<u>45,061.99</u>	
Gross profit on trading		Shs.	<u>10,644.71</u>

SHOP

Sales		414,541.35	
<u>Less:</u>			
Stock - 1st June, 1970		153,020.75	
<u>Add:</u>			
Purchases		180,862.45	
		<u>333,883.20</u>	
<u>Less:</u>			
Stock - 31st May, 1971		62,947.43	
Cost of sales		<u>270,935.77</u>	
Gross profit on trading		Shs.	<u>143,605.58</u>

SIMBA TOURS AND LODGES LIMITEDTRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1971LANDROVER HIRE AND WORKSHOP SALES

Shs.

Sales		938,621.80
<u>Less:</u> <u>Direct expenditure:</u>		
Wages	125,271.40	
Repairs	151,925.90	
Petrol and oil	123,570.90	
Permits to crater	78,148.45	
Workshop expenses	8,899.35	
		<u>487,816.00</u>
Gross profit on trading		Shs. <u><u>450,805.80</u></u>

SIMBA TOURS AND LODGES LIMITED

SUMMARY OF FIXED ASSETS - 31ST MAY, 1971

	C As at 1.6.70	O Additions	S Sales	T To 31.5.71	D E P Tot 31.5.70	R E C I A T I O Adjustment Charged to on disposal P & L A/C	N Accumulated Depreciation	Net	
<u>BUILDINGS</u>	749,886.14	-	-	749,886.14	433,028.14	-	74,988.00	508,016.14	241,870.00
<u>TRACTORS</u>	23,209.00	-	-	23,209.00	23,208.00	-	-	23,208.00	1.00
<u>MOTOR VEHICLES</u>	560,103.35	-	16,000.00	544,103.35	381,418.35	8,000.00	136,025.00	509,443.35	34,660.00
<u>MACHINERY AND EQUIPMENT</u>	224,973.15	31,990.00	-	256,963.15	118,336.15	-	32,120.00	150,456.15	106,507.00
<u>WORKSHOP EQUIPMENT</u>	30,456.05	775.00	-	31,231.05	25,059.05	-	3,904.00	28,963.05	2,268.00
<u>FURNITURE AND FITTINGS FITTINGS</u>	79,211.73	1,936.00	-	81,147.73	59,826.73	-	10,143.00	69,969.73	11,178.00
Shs.	<u>1,667,839.42</u>	<u>34,701.00</u>	<u>16,000.00</u>	<u>1,686,540.42</u>	<u>1,040,876.42</u>	<u>8,000.00</u>	<u>257,180.00</u>	<u>1,290,056.42</u>	<u>396,484.00</u>

SIMBRA TOURS AND LODGES LIMITEDBALANCE SHEET - 31ST MAY, 1972.

<u>1971</u> Shs.	<u>FIXED ASSETS:</u>	<u>Cost</u> Shs.	<u>Accumulated</u> <u>Depreciation</u> Shs.	Shs.
241,870	Buildings	749,886	583,004	166,882
34,661	Motor vehicles and tractors	693,474	598,601	94,873
108,775	Machinery and equipment	300,017	215,285	84,732
11,178	Furniture and fittings	84,223	80,497	3,726
<u>396,484</u>		<u>1,827,600</u>	<u>1,477,387</u>	<u>350,213</u>
	<u>GOODWILL:</u>			
100,000	At cost less amount written off			100,000
	<u>ASSOCIATED COMPANIES:</u>			
2,221,542	Jambo Jambo Lodge Limited			2,511,386
<u>2,718,026</u>				<u>2,961,599</u>
	<u>CURRENT ASSETS:</u>			
202,639	Stocks at director's valuation		296,502	
	Debtors and prepayments	431,376		
	Less: Provision for bad and doubtful debts	38,707		
375,080			392,669	
4,650	Loans to staff		4,425	
109,318	Directors' current accounts		122,799	
97,814	Cash at bank		159,602	
11,490	Cash in hand and float		50,115.	
<u>800,991</u>			<u>1,026,112</u>	
	<u>Deduct:</u>			
	<u>CURRENT LIABILITIES:</u>			
36,744	Cancellation fees waived	142,539		
	Creditors and accrued charges	620,898		
574,945	Deposits from customers	10,910		
13,905	Hire purchase creditors	52,137		
-	Corporation tax liability	741,622		
826,280				
<u>1,451,874</u>			<u>1,568,106</u>	
(650,883)				(541,994)
<u>2,067,143</u>				<u>2,419,605</u>
	<u>Representing:</u>			
	<u>SHARE CAPITAL:</u>		<u>Authorised</u>	<u>Issued and Fully paid</u>
320,000	Shares of Shs.20/= each		340,000	320,000
	<u>REVENUE RESERVE:</u>			
1,747,143	Retained profit			2,099,605
<u>2,067,143</u>				<u>2,419,605</u>
Director.			
Director.			

SIMBA TOURS AND LODGES LIMITED

PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1972

1971
Shs.

848,416 Profit for the year

Shs.
670,528

After charging:		
257,180	Depreciation	187,331
14,000	Audit and accountancy fees	20,000
115,275	Directors remuneration	95,584
32,993	Staff commission	23,468

1,000,000 Proposed dividend written back

1,848,416

670,528

Deduct:

401,384 Provision for corporation tax 283,424

8,112 Underprovision for corporation tax in previous years 11,440

- Penalties imposed on previous years' taxes 23,202

409,496

318,066

1,438,920

352,462

308,223 Unappropriated profits - 1st June, 1971

1,747,143

1,747,143 RETAINED PROFIT

Shs. 2,099,605

78,106	Directors	8,718
4,600	Staff	1,070
3,417	Administrative	700
38,078	Insurance	47,528
700	Subscriptions and donations	1,150
8,437	Stationery, postage and	8,437
-	Risk insurance interest	1,030
21,774	Interest	18,337
3,704	Bad debts provision	21,700
118,510	Dividend Reserve	118,510

SIMBA TOURS AND LODGES LIMITED

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1972.

1971

Shs.

Shs.

		Gross profit per trading account:		
1,439,701	Accommodation			1,387,402
90,178	Dining room			21,373
169,952	Bar			109,193
10,645	Cigarettes			10,068
143,605	Shop			22,846
450,805	Land rover hire and workshop			514,046
<hr/>				<hr/>
2,304,887				2,064,933
249,152	Cancellation fees			205,977
-	Creditors written off			25,112
9,040	Profit on exchange less bank charges			8,571
<hr/>				<hr/>
2,563,079				2,304,593
<hr/>				<hr/>
125,763	Salaries and commissions	119,305		
54,000	Managing director's salary	52,000		
61,275	Managing director's commission	43,584		
214,687	Maintenance and general wages	235,144		
	Staff accommodation and			
98,400	food expenses	98,400		
77,000	Staff transport	66,500		
<hr/>		<hr/>		
631,125				614,933
<hr/>				<hr/>
74,932	General repairs and			
	renewals	47,423		
36,509	Electric plant running expenses	32,040		
23,390	Water	26,176		
24,000	Land rent	24,000		
39,756	Crockery, glassware and linen	42,203		
<hr/>		<hr/>		
198,587				171,842
<hr/>				<hr/>
1,900	General vehicles and tractors			
	running expenses	10,788		
	Travelling expenses:			
72,062	Directors	60,563		
24,811	Staff	9,830		
16,421	Radio and telephone expenses	17,990		
11,032	Postages and telegrams	8,491		
<hr/>		<hr/>		
126,226				107,662
<hr/>				<hr/>
233,493	Travelling agents' commission and discount	232,673		
	Entertaining expenses:			
14,106	Directors	9,343		
4,682	Staff	1,878		
3,412	Advertising	760		
38,615	Insurance	47,324		
770	Subscriptions and donations	1,190		
	Newspapers, magazine and			
6,132	books	2,484		
-	Hire purchases interest	1,639		
11,574	Licences	15,137		
3,126	Bad debts written off	80,966		
<hr/>		<hr/>		<hr/>
315,910	Carried forward	393,394	894,437	2,304,593

SIMBA TOURS AND LODGES LIMITED

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1972

1971 Shs.				Shs.
315,910	Brought forward	393,394	894,437	2,304,593
143	Debt collection charges	-		
31,582	Provision for bad and doubtful debts	1,306		
1,739	Legal and professional fees	3,853		
14,000	Audit and accountancy fees	20,000		
17,337	National Provident Fund contributions	21,451		
<hr/>		<hr/>	440,004	
380,711				
9,900	Arusha office rent	18,000		
2,031	Rent tax	2,742		
26,165	Uniforms	27,884		
1,893	Medical expenses	2,423		
3,691	Office expenses	2,969		
5,577	General expenses	3,492		
41,228	Stationery	38,970		
5,500	Loss on sale of fixed assets	-		
257,180	Depreciation for the year	187,331		
24,849	Publications and promotional expenses	15,813		
<hr/>		<hr/>	299,624	
378,014				
<hr/>				1,634,065
1,714,663				<hr/>
<hr/>				
848,416	Net profit before taxation			Shs. 670,528
<hr/> <hr/>				<hr/> <hr/>

SIMBA TOURS AND LODGES LIMITEDTRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1972DINING ROOM

		Shs.
		1,110,966
Sales	43,572	
Less: Stock - 1st June, 1971	947,577	
Add: Purchases	<u>991,149</u>	
	90,640	
Less: Stock - 31st May, 1972	<u>900,509</u>	
Cost of sales		<u>218,457</u>

Less:Direct expenditure:

Wages	154,736	
Fuel	20,000	
Transport	12,523	
Firewood	<u>9,820</u>	
		<u>197,079</u>

Gross profit on trading

Shs. 21,378ACCOMMODATION:

Sales	1,731,605	
Less: Stock - 1st June, 1971	4,000	
Add: Purchases	<u>96,118</u>	
	100,118	
Less: Stock - 31st May, 1972	<u>4,000</u>	
Cost of sales		<u>96,118</u>

Less:Direct expenditure:

Wages	106,554	
Accommodation conservation fees	77,896	
Fuel	50,000	
Transport	<u>13,635</u>	
		<u>248,085</u>

Gross profit on trading

Shs. 1,387,402

SIMBA TOURS AND LODGES LIMITEDTRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1972B A R

		Shs.
Sales		427,341
Less: Stock - 1st June, 1971	49,710	
Add: Purchases	260,055	
	<u>309,765</u>	
Less: Stock - 31st May, 1972	50,965	
Cost of sales		<u>258,800</u>
Direct expenditure:		168,541
Wages	56,539	
Transport	2,809	
	<u>59,348</u>	
Gross profit on trading		Shs. <u>109,193</u>

CIGARETTES:

Sales		47,235
Less: Stock - 1st June, 1971	2,653	
Add: Purchases	37,945	
	<u>40,598</u>	
Less: Stock - 31st May, 1972	3,431	
Cost of sales		<u>37,167</u>
Gross profit on trading		Shs. <u>10,068</u>

SHOP:

Sales		264,446
Less: Stock - 1st June, 1971	62,947	
Add: Purchases	229,293	
	<u>292,240</u>	
Less: Stock - 31st May, 1972	50,640	
Cost of sales		<u>241,600</u>
Gross profit on trading		Shs. <u>22,846</u>

SIMBA TOURS AND LODGES LIMITED

TRADING ACCOUNT FOR THE YEAR ENDED 31ST MAY, 1972

LANDROVER HIRE AND WORKSHOP SALES

Shs.

Sales 1,035,331

Less:

Direct expenditure:

Wages 148,823
 Repairs 117,500
 Petrol and oil 122,675
 Permits to crater 104,227
 Workshop expenses 9,760
 Landrover hire conservation fees 18,300

521,285

Gross profit on trading

Shs. 514,046

SIMBA TOURS AND LODGES LIMITED

SUMMARY OF FIXED ASSETS - 31ST MAY, 1972.

	C	D	S	T	D E P R E C I A T I O N			
	As at <u>1.6.71</u>		<u>Additions</u>	To <u>31.5.72</u>	To <u>31.5.71</u>	Charged to <u>P & L A/C</u>	Accumulated <u>Depreciation</u>	<u>Net</u>
<u>BUILDINGS</u>	749,886			749,886	508,016	74,988	583,004	166,882
<u>TRACTORS</u>	23,209			23,209	23,208	-	23,208	1
<u>MOTOR VEHICLES</u>	544,103	126,162		670,265	509,443	65,950	575,393	94,872
<u>MACHINERY AND EQUIPMENT</u>	256,963	10,679		267,642	150,456	33,455	183,911	83,731
<u>WORKSHOP EQUIPMENT</u>	31,231	1,144		32,375	28,963	2,411	31,374	1,001
<u>FURNITURE AND FITTINGS</u>	81,148	3,075		84,223	69,970	10,527	80,497	3,726
	<u>She. 1,686,540</u>		<u>141,060</u>	<u>1,827,600</u>	<u>1,290,056</u>	<u>187,331</u>	<u>1,477,387</u>	<u>350,213</u>

JAMBO JAMBO LODGE LIMITEDBALANCE SHEET - 31ST MAY, 1972

<u>FIXED ASSETS</u>	<u>Cost</u> Shs.	<u>Depreciation</u> Shs.	Shs.
Land and buildings	2,666,394.90	106,655.90	2,559,739.00
Motor vehicles	3,000.00	750.00	2,250.00
Machinery and equipment	174,457.15	21,007.15	152,650.00
Linen crockery and glassware	119,759.70	14,969.70	104,790.00
Camping tents with equipment	108,000.00	13,500.00	94,500.00
Furniture and fittings	150,633.70	18,829.70	131,804.00
	<u>3,222,245.45</u>	<u>176,512.45</u>	<u>3,045,733.00</u>
 <u>CURRENT ASSETS:</u>			
Stocks at cost and valuation		65,638.74	
Debtors and prepayments		264,433.75	
Cash at bank		80,243.70	
Cash in hand and float		22,077.80	
		<u>432,413.90</u>	
 <u>Deduct:</u>			
<u>CURRENT LIABILITIES:</u>			
Creditors and accrued charges	477,175.35		
Deposits from customers	5,127.00		
Directors' loan account	100,000.00		
Amounts due to associated company	2,511,386.00		
		<u>3,093,688.35</u>	
			<u>(2,661,274.36)</u>
			<u>Shs. 384,458.64</u>
 <u>Representing:</u>			
<u>SHARE CAPITAL:</u>		<u>Authorised</u>	<u>Issued and Fully paid</u>
Shares of Shs.20/= each		<u>3,000,000.00</u>	538,000.00
 <u>ACCUMULATED LOSSES TO DATE</u>			<u>153,541.36</u>
			<u>Shs. 384,458.64</u>

.....Director.

.....Director.

Note: No comparatives are given because the financial year ends in November, 1972 but above accounts are prepared upto May, 1972 for comparison purposes.

JANBO JANBO LODGE LIMITED

PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE PERIOD ENDED 31ST MAY, 1972

	Shs.
Loss for the period	41,964.11

After charging:	
Depreciation	176,512
Audit and accountancy fees	12,000
Directors' remuneration	177,600

Accumulated losses to date	111,577.25
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Accumulated losses - 31st May, 1972	Shs. 153,541.36
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Note: No comparatives are given because the financial year ends in November, 1972, but above accounts are prepared upto May, 1972 for comparison purposes.

APPENDIX CONTINUEDSIMBA TOURS AND LODGES LIMITED:SUGGESTED SOLUTIONS TO THE CASE³ANSWER (a)

Bearing in mind that the company may be nationalized or subject to Tanzania Tourist Corporation, participation, the shareholders feel that it is desirable to absorb as much as possible of the retained profits. To this end, Mrs. Carmichael who is the principal shareholder and Director of Simba Tours and Lodges Limited suggests that the company should declare as much of the retained profits as dividends.

This is not possible. As the case mentions, in early 1972, the government of Tanzania worried about the amount of foreign exchange flowing out of the country in the form of Dividends, passed the Companies (Regulation of Dividends and Surpluses and the Miscellaneous Provisions) Act, 1972.

Section 7(1) of the Act concerning "Limitation on Dividends" is quoted in the case. Using this Section of the Act, our DIVIDENDS MODEL⁴ shown overleaf shows that legally it would be permissible to pay dividends of upto Shs. 600,465/- only. So although the retained profit at the end of May 1972 is Shs. 2,099,605/-, only shs. 600,465/- could be paid out as Dividends.

DIVIDENDS MODEL USED FOR ANSWERINGPROBLEM aSIMBA TOURS AND LODGES LIMITED

FORM FOR CALCULATION OF RESTRICTIONS OF DIVIDENDS UNDER THE COMPANIES (REGULATIONS AND SURPLUSES AND MISCELLANEOUS PROVISIONS) ACT 1972 WHICH OPERATES FROM 15th JAN. 1972 IN RESPECT OF ALL COMPANIES INCORPORATED IN TANZANIA.

The maximum permitted dividend is the smallest of (a) or (b) or (c) below:-

Section 7 (1)

(a)	Paid up capital of company	Shs. 320,000
	*Reserves required by Act namely 25% of paid up capital before dividend can be declared	Shs. 80,000
	Total accumulated reserves at balance sheet date	Shs. 1,747,143
	Add Net Profit for the year after tax	Shs. 352,462
		Shs. 2,099,605
	Less reserves as above*	Shs. 80,000
	Maximum permitted dividend	Shs. 2,019,605

or (b) The largest of:-

(i)	Profit/(Loss) after tax for		
	previous year	1971	Shs. 438,920
	Penultimate year	1970	764,625
	Prepenultimate year	1969	597,850
			Shs. 1,801,395

APPLICABLE Average being maximum permitted dividend Shs. 600,465

(ii) 80% of profits of proceeding year being maximum permitted dividend Shs. 351,136

(iii) If first year of trading 80% of profit
Maximum permitted dividend Shs. N/A

or (c) FOR SPECIFIED COMPANIES ONLY FROM 18th AUGUST, 1972 UNDER THE SPECIFIED COMPANIES FURTHER LIMITATIONS OF DIVIDENDS ACT

Maximum permitted dividend is 20% of company's approved net worth

i.e. $\frac{20}{100}$ share capital + reserves of the last audited balance sheet

= $\frac{20}{100}$ (320,000 + 1,747,143)

= Shs. 413,428.

N/A

ANSWER (b)⁵

PAMELL BELLHOUSE MWANGI AND COMPANY

P.O. Box 180,
Flaviana Building,
Boma Road,
Tanzania

OUR REF: NCL/2/1041

31st May, 1973

Dear Shareholder,

SIMBA TOURS AND LODGES LIMITED

We enclose draft accounts for the company in respect of the year ended 31st May, 1972 for your consideration and comments.

We refer to the question of dividend. At present, no dividend is shown (although legally it would be permissible to pay one upto Shs. 600,465/-), and in our opinion, the company cannot truly afford to pay one at this time as there is not enough cash. However, bearing in mind that the company may be nationalized or subject to Tanzania Tourist Corporation participation, it is desirable to absorb as much as possible of the retained profits. We therefore suggest that a bonus issue of shares be made. In view of the company's present capital position,

Viz:	Authorized	340,000/-
	Issued	320,000/-
	Reserves	2,100,000/-

it would be necessary to increase the authorised share capital by special resolution. If for instance, it were increased say

one million shillings, there could be a 2:1 scrip leaving reserves of Shs. 1,440,000/-, still in excess of the legal requirement of at least 25% of share capital (N.B. Maximum Scrip is Shs. 1,616,000/-). It would of course be necessary to get Exchange Control permission for such a scheme; but it would be well worth trying to obtain. The Tanzania Government are very good at saying that they will participate for per value of the shares, their thinking being along the lines that this is the original capital brought in and the profits therefore belong to Tanzania anyway.

(2) *Para 2 has already called Simba Tours and Lodges*

The next matter to be dealt with is that of the sum due by Jambo Jambo Lodge Limited to Simba Tours and Lodges Limited. Bearing in mind possible future developments as outlined above, it is desirable that this be eliminated in order to avoid indirect government control over Jambo Jambo Lodge Limited, and also to keep the money in the hands of the present shareholders. The letter from Mrs. Carmichael dated 17.4.73 is very unsatisfactory in that she appears to have the wrong idea about the amount owing to Simba Tours and Lodges Limited by Jambo Jambo Lodge Limited. This is an asset of the company (Simba Tours and Lodges Limited) and any note or other piece of paper relating to this indebtedness is not going to be payable to any shareholder but by them. There are several ways of dealing with this. It would be possible for the shareholders to assume the liability for the debt to Simba Tours and Lodges Limited and be issued with debentures

for the same amount from Jambo Jambo Lodge Limited. However, this would merely mean replacing the loan from Jambo Jambo Lodge Limited with loans to the shareholders. In other words, this would merely make the shareholders indebted to Simba Tours and Lodges Limited and could give rise to taxation difficulties.

In our opinion, a more satisfactory, although more radical, solution would be a complete financial reconstruction of the organisation as detailed below:

- (1) Form a new company called Simba Tours and Lodges Limited.
- (2) Change the name of the present company to Simba Enterprises Limited (or something similar).
- (3) Have a professional valuation made of the Lodge and all other assets of the present Simba Tours and Lodges Limited (except cash and the Jambo Jambo Lodge Limited loan).
- (4) Simba Enterprises Limited to sell the "Business" to the new Simba Tours and Lodges Limited, in exchange for shares and loan.
- (5) The proportion of shares and loan would be agreed later; but be such that the authorized share capital is large enough to be able to offer Tanzania Tourist Corporation shares at par to the extent to which they wish to participate.

(6) The capital introduced by Tanzania Tourist Corporation in taking up their shares would be used in whole or in part to repay the loan from Simba Enterprises Limited, which company would remain in the hands of the original shareholders. (Note: this loan refers to one stated in step (4) above). Thus the debt due from Jambo Jambo Lodge Limited would remain under the control of the original persons. In other words the shareholders will retain the original company with the loan and cash in hand although it may be necessary for working capital to be introduced to the new company (i.e. Simba Enterprises Limited), and this can of course be done either for issue of shares or by way of loan.

Please let us know if this scheme is of interest to you and then, (perhaps while the directors are in this country), negotiations, etc., can be commenced. Should it be decided to go ahead, we would bring one of our Nairobi partners in to assist, in order to avail ourselves of his greater experience and knowledge of matters such as this. (For example, problems may arise with respect to certificate of approved enterprise).

If this course of action is decided upon, then it is not so vital to issue bonus shares in Simba Tours and Lodges Limited at present, though we think it would still be advisable

and would strengthen the shareholders' case in the event of and investigation into the company by Tanzania Tourist Corporation when negotiations for participation are being pursued.

Yours faithfully,

Resident Manager (P.B.M.)

Mr. Cundin, one of the principal shareholders and directors outlined the contents of the Memorandum and explained the future control of State Tours and Lodges Limited by Tanzania Tourist Corporation, with various organizations having governmental connections. It was stressed that unless a local private organization participated in the capital of the company, the government would be reluctant to surrender the control and right of ownership of State Tours and Lodges Limited which expires in 1974.

Mr. Cundin had discussed the possible purchase of shares by Bagmati Development Finance Company Limited (a private organization) with the General Manager, Mr. Mwanza. A letter from Mr. Mwanza, outlining the advantages of the company and the plans for the gradual take-over of the shares in State Tours and Lodges Limited and State State Lodges Limited was sent by the Resident Manager, Mr. Peter Cook.

Further discussions followed on the proposal from T.T.C. Shareholders were given time to work-out the terms under which the proposals would be acceptable to them.

ANSWER (c)

This point in problem (3) was raised in the Annual General Meeting held in Tanzania on Saturday, 28th July, 1973 at 2:40 p.m.

Mrs. Carmichael, one of the principal shareholders and directors outlined the contents of the discussions which she had concerning the future control of Simba Tours and Lodges Limited by Tanzania Tourist Corporation, with various organisations having governmental connections. It was stressed that unless a local parastatal organisation participated in the capital of the company, the government would be reluctant to renew the lease and right of occupancy of Simba Tours and Lodges Limited which expires in 1974.

Mrs. Carmichael had discussed the possible purchase of shares by Tanganyika Development Finance Company Limited (a parastatal organisation) with its General Manager, Mr. Madete. A telex from Mr. Madete, setting out the advantages of the link-up and the scheme for the gradual take-over of the shares in both Simba Tours and Lodges Limited and Jambo Jambo Lodge Limited was read by the Resident Manager, Mr. Peter Copp.

Further discussions followed on the proposal from T.D.F.L. Shareholders were given time to work-out the terms under which the proposals would be acceptable to them.

It was resolved that the shareholders of Simba Tours and Lodges Limited, and Jambo Jambo Lodge Limited being the same persons, were not interested in selling a portion of their shareholding in any merger terms which would require them to relinquish direct management of their companies.

A reasonable solution to the problem was that since they were not interested in selling a portion of their shareholding in any merger terms (since if they did they were worried of the problems raised in the case), the alternative would be to consider a complete sale of the issued share capital of both the companies at some agreed upon price. This alternative was put forward to the shareholders and they agreed to it. The shareholders said that they would be interested in a sale of the issued share capital of both the companies at some agreed upon price.

The question here concerned the determination of the fair market price at which the Directors and shareholders of Simba Tours and Lodges Limited should agree to sell 100% of the shareholding of Simba Tours and Lodges Limited and Jambo Jambo Lodge Limited to the government of Tanzania.

Below are excerpts from the report which we prepared for the shareholders:

(1) PRICE

Determination of the fair market price at which the shareholders of Simba Tours and Lodges Limited may agree to sell 100% of the shareholding of Simba Tours and Lodges Limited and Jambo Jambo Lodge Limited to the Government of Tanzania.

(2) In the absence of the necessary information, we accepted the net asset value established by PANWELL BELHOUSE MWANGI AND COMPANY accountants and auditors. The net asset value of Simba Tours and Lodges Limited was Shs. 2,419,605/- as at 31st May, 1972 and the net asset value of Jambo Jambo Lodge Limited was Shs. 334,459/- as at 31st May, 1972.

(3) Theoretically, the valuation procedure is straight forward. The government of Tanzania is buying a stream of future returns. All that it is buying is the difference between the company's cash flow before the acquisition, and the cash flow after the acquisition. The difference needs to be estimated, discounted, and summed to give its present value. This is the present value of the receipts from the purchase.

It can be expressed mathematically as:⁶

$$\text{PVR} = \frac{c}{i} \left[1 - \frac{1}{(1+i)^n} \right]$$

where PVR = present value of the receipts (returns)
 c = increased cash flow per annum
 i = discount factor
 n = number of years

The above approach does not allow for the growth in the cash flow per year. It assumes an annuity. The Basic model which takes into account of cash flows which are different every year is the following:

$$\begin{aligned} \text{PVR} &= \sum_{n=0}^n C_n (1+i)^{-n} \\ &= C_0(1+i)^{-0} + C_1(1+i)^{-1} + C_2(1+i)^{-2} \dots \dots \dots \\ &\quad + C_n(1+i)^{-n} \end{aligned}$$

But there are difficulties in the practical application of the approach. These are:

- (a) Forecasting future annual returns;
- (b) The number of years' returns on which the calculation will be based;
- (c) The appropriate discount rate.

In the East African setting there is a further practical difficulty when it comes to research. We think that one of the main drawbacks which one encounters when carrying out research in East Africa is the lack of appropriate data and lack of cooperation from the people involved. Under these circumstances one should not expect a research project to reveal everything.

As a result, we have not used the model described above in our analysis. The management of Simba Tours and Lodges Limited was not in a position to work out these annual cash flows with us. We were also not in a position to estimate these annual cash flows because the estimated returns are dependent on many things. As an example, on occasions, even though the purchase has been made, the acquiring company (in this case Tanzania Tourist Corporation or T.D.F.C. Limited) still has to incur additional outgoings: loans, for instance may have to be provided for the subsidiary. The estimated returns from the purchase may be dependent on this additional outlay, which must obviously be taken into account when the benefits of the possible acquisition are assessed. The returns have to justify the purchase price plus any additional investment that may be required. There are other such cases too.

As a result of these problems, we have made use of the valuation method as suggested by Meigs, Johnson and

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Keller⁷ which is a minor modification of the Super Profit Method in that instead of multiplying annual superior earnings by a number of years to calculate goodwill and speak of the result as the "number of years of superior earnings purchased", Meigs and Johnson say that one should calculate the present value of 'n' number of years of superior earnings at some percentage interest rate which was the rate of return used on net assets employed to calculate Normal Profit. In this way we still make use of the Basic Model given below:

$$PVR = \frac{C}{i} \left[1 - \frac{1}{(1+i)^n} \right]$$

where PVR = Present Value of n number of years of Superior earnings of C at i%, where i is the rate of return used on net assets employed to calculate Normal Profit.

- (4) We shall take the last 3 years profits of Simba Tours and Lodges Limited and average them to get an idea of normal profits for this enterprise. For Jambo Jambo Lodge Limited, our Goodwill calculation will be based on average net profits before taxation of Shs. 100,000/-.
- (5) We shall calculate the present value of 10 years, 8 years and 7 years of Superior earnings at 20%, 25% and 30% respectively. This will give us the figure for Goodwill.

(6) COMPUTATION OF PURCHASE PRICE

<u>High Valuation</u>	<u>Medium Valuation</u>	<u>Low Valuation</u>
2,420,000	2,420,000	2,420,000
384,000	384,000	384,000
<u>2,804,000</u>	<u>2,804,000</u>	<u>2,804,000</u>
950,000	950,000	950,000
484,000(20%)	605,000(25%)	726,000(30%)
<u>466,000</u>	<u>345,000</u>	<u>224,000</u>
<u>1,953,705(10 yrs)</u>	<u>1,149,178(8 yrs)</u>	<u>627,670(7yrs)</u>
306,891(10 yrs)	179,871(8 yrs)	97,513(7 yrs)
<u>5,064,596</u>	<u>4,133,049</u>	<u>3,529,183</u>

(a) Computation of the Net Asset Value

Following our review of the balance sheet we have included the net asset value of Simba Tours and Lodges Limited and Jambo Jambo Lodge Limited at the figure of Shs. 2,420,000/- and Shs. 384,000/- respectively, as shown in the audited accounts.

(b) Computation of Goodwill

In our opinion the value of Goodwill in any commercial enterprise is in its ability to earn above normal profits (super profits). In our findings we have found that for Tourist companies the return on net assets employed is in the region of 30%. As such we established that the most important objective of the government's decision would be the ability of these 2 companies to return at least 30% on net assets employed (before taxes).

For the purposes of bargaining we have determined the super profits by reference to a "normal profit" of 20%, 25% and 30% before taxes on net assets employed.

We have then computed 3 values for goodwill based on selling 10 years, 8 years and 7 years of the super profits. This procedure has been done for both companies.

On the basis of this, we arrive at the following selling price for 100% of the shares:

	Purchase Price	Rate of Return on Net Assets Employed
High Purchase Price by Government	Shs.5,064,596/-	20%
Medium Purchase Price by Government	Shs.4,133,049/-	25%
Low Purchase Price by Government	Shs.3,529,185/-	30%

(7) Method of Selling

We were also asked as part of our brief to advise how the shareholders might sell their interest in Simba Tours and Lodges Limited and Jambo Jambo Lodge Limited. We would make the following specific recommendations:-

(a) Selling Price

We would suggest that the shareholders should initially approach the government bodies concerned and ask for a price of Shs. 5,100,000/- in respect of 100% of the issued shares of Simba Tours and Lodges Limited and Jambo Jambo Lodge Limited.

It is to be anticipated that the Government bodies concerned will attempt to decrease the selling price and in our opinion it would be acceptable to decrease the selling price to an ultimate figure of Shs. 3,500,000/-.

(b) Terms of Payment

We recommend that an approval should be obtained from the Exchange Control Department that a substantial amount would be approved by them for remittance by shareholders to their countries of origin.

A down payment of at least 35% of the sale price agreed should be expected and the balance together with interest thereon should be paid equally over a period of 3-5 years.

The report was given due respect by the shareholders and Directors of the two companies concerned.

FOOTNOTES AND REFERENCESChapter One: Footnotes and References

1. The author was inspired to write the thesis in this area and to choose the present title for the thesis after going through A.M. Bourn's paper, 'Economics and Accounting', in Accountancy, (March, 1966), pp. 145-159. A large part of chapter one is drawn upon this paper.
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4. op.cit., p. 619.
5. ibid., pp. 619-624.
6. Quoted in: A.M. Bourn, "Valuation and Profit" in A.M. Bourn (ed), Studies in Accounting for Management Decision, (London: McGraw-Hill Publishing Company Limited, 1969), p. 77.
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12. Paul A. Samuelson, Economics, (New York: McGraw-Hill Book Company, Inc., 1973), pp. 619-624.

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3. ibid., pp. 43-44.
4. Bion B. Howard and M. Upton, Introduction to Business Finance, (New York: McGraw-Hill Book Company, 1953), pp. 21-22.
5. Knight, op.cit., p. 35.
6. Frank W. Taussing, Principles of Economics, (New York: The MacMillan Company, 1947), p. 48.
7. Quoted in Maurice Dobb, On Economic Theory and Socialism, (London: Routledge & Kegan Paul Limited, 1955), p. 183.
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14. 1948 Statement of the Committee on Accounting Concepts and Standards, op.cit., p. 15.
15. op.cit., p. 46.

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46. ibid., p. 207-208.
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4. R.S. Gynther, Accounting for Price-Level Changes: Theory and Procedures, (Oxford: Pergamon Press, 1966), pp. 16-18.
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Appendix:Footnotes and References

1. This was a case study in the Tanzanian environment. The author had the chance to work on the problem of dividend declaration and/or distribution, described in the case, when he was doing some temporary accounting and auditing work with Pennell Bellhouse Mwangi and Company, a firm of Chartered Accountants, in Arusha. For the purpose of the thesis, the author made a case study out of it. The case shows the effect of the application of the COMPANIES (REGULATION OF DIVIDENDS AND SURPLUSES AND MISCELLANEOUS PROVISIONS) ACT 1972, on a certain company in Tanzania - Simba Tours and Lodges Limited. The case study as well as its solution is described in full in the sense that other alternatives worked out by the author and the Resident Manager of PBM & Co., Mr. P. Copp, are also given. The problem of company valuation is a case in point.
2. The author of the thesis.
3. This suggested solution is based on the three problem areas mentioned earlier in the body of the case.

4. The Dividends Model was arrived at from Section 7(1) of the Companies (Regulation of Dividends and Surpluses and the Miscellaneous Provisions) Act, 1972, which describes this model in verbal form.
5. The suggested solution to problem (b) has been put in the form of a letter addressed to the shareholders and letting them know of the best ways to deal with the issues.
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