Factors affecting the Choice of Prevailing Income Measuring Concepts among Manufacturing Companies

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ABSTRACT

The significant of income to any business entity cannot be overemphasized. Income is the residue that is available for distribution to the shareholders which ensures the maintenance of the capital (Glautier A, 2011,). Income is a basic and important item of financial statement that has various uses in various contexts. It is generally perceived as a basis for taxation and redistribution of wealth, a determination of dividend payment policies and investment and decision making guide and element of prediction (Riahi-Belkaoui 2002).The choice of income measurement concepts which has a direct bearing on the operating performance reporting of an organisation is informed by some factors which this paper sought out to examined. To achieve the objective of this study, opinion of selected staff of Fidson Nigeria Plc and Nestle Nigeria Plc Lagos State were sought through the use of questionnaire and besides relevant theories and concepts were reviewed The questionnaire were analysed with the use of SPSS 17 .The evidence shows that the choice of accounting concepts as the prevailing income measurement concept is premised on historical cost accounting given its unconditional and long standing acceptance of this version of income by the accounting profession and the business world. The paper finally recommends that the use of other income measurement such as the economic view should be preferred due to some militating factors against the use of accounting income which is historical in nature.

Keywords: Income measurements concepts, Financial Statement, Worth of Capital

INTRODUCTION

Income is the consumption and savings opportunity gained by an entity within a specified time frame, which is generally expressed in monetary terms (Barn, 2004). However, for households and individuals, income is the sum of all the wages, salaries, profits, interests 'payments, rents and other forms of earnings received in a given period of time(Scott 2003). For firms, income generally refers to net-profit: what remains of revenue after expenses have been subtracted. In the field of public

economics, it may refer to the accumulation of both monetary and non-monetary consumption ability, the former being used as a proxy for total income. Economists refer to income as a measure of "better-offness."Thus, economic income represents an increase in command over goods and services. Such notions of income capture operating successes, as well as good fortune from holding assets that may increase in value. In contrast, accounting income tends to focus on the effects of transactions and events that are evidenced by exchange transactions. However, this paper was to explicitly distinguish, both conceptually and empirically, between income concepts both in accounting and economic perspectives. Also, instead of dwelling on income, accountants turned their efforts to making historical cost based financial statements more useful to the users of financial accounts. As a practical matter, it seems impossible to prepare financial statements that are both completely relevant as well as reliable. Historical cost accounting is relatively reliable because the cost of an asset or liability to an enterprise is usually an objective number that is less subject to errors of estimation and bias than are present value calculations. However, historical cost may lack relevance as compared with other income concepts such as the economics and the business profits. While historical cost, market value and present value may be similar in regard to the date of acquisition, market values and present values will change over time as real world conditions change. Nevertheless, accountants continue to use historical cost bases accounting for major asset types because they are willing to trade off a considerable amount of relevance to obtain reasonable reliability. Problem analysis all the statistics gathered in manufacturing companies' surveys, perhaps none is more ubiquitous than income, or more universally germane to a wide array of important policy issues.

Income reporting is generally a two-stage process involving first the reporting of income sources, and then the reporting of amounts received from those sources. Response errors can occur at either stage. An entire source of income can be misreported, leading to either the respondent's failure to report true income or his or her "false positive" reporting of income not actually received. Or, the source of income may be reported correctly but the amount received from that source can be misreported. Again, we draw this distinction because of the likelihood that different cognitive mechanisms underlie these different types of error, implying the need for different survey design solutions. The objectives are to investigate if the income measurement that remain general use in the Nigeria manufacturing companies .and to enumerate factors affecting the choice of prevailing income measurement.**.** Research questions are (i) Does income measurement remain general use in the Nigeria manufacturing companies? (ii) What are the factors affecting the choice of prevailing income measurement. While the hypothesis are

Ho: The more perfect the market, the more useful market values will be in measuring income based on changes in the value of assets and liabilities.

Hi: The more perfect the market, the more useful market values will not be in measuring income based on changes in the value of assets and liabilities.

The study is significant as it will benefit the management and other similar organizations who will find this study very useful. While Scope of the study tends to look at factors affecting the choice of prevailing income measurement among selected manufacturing companies in Nigeria. Nestle Plc And Fidson Plc manufacturing company was choosing because their long standing performance among Nigerian manufacturing companies. However, the study may not be able to cover the entire aspect of income measurement as further researches will dwell on that.

LITERATURE REVIEW

General Review

In 1991, Robert Elliott and Peter Jacobson drew attention to the fact that the new wealth-creation method of information era (see Figure 1) requires more sophisticated information.

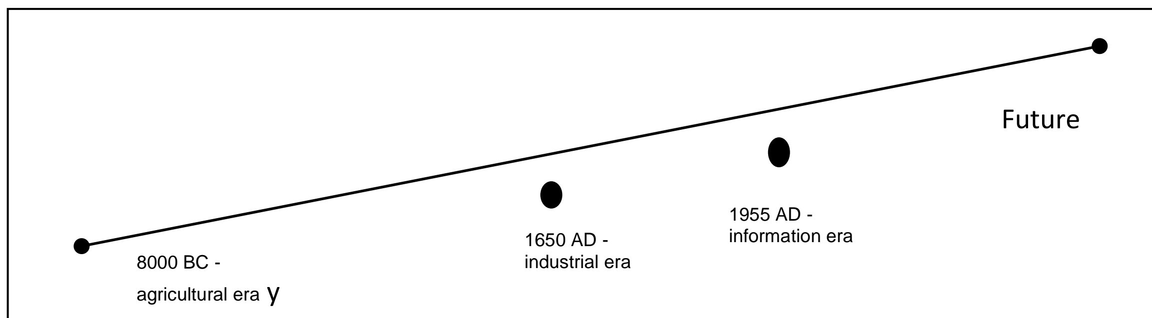

Figure 1. Methods of wealth creation (Source: Elliot, R. K. and Jacobson, P. D. 1991)

Through the ages, mankind has developed three fundamentally different methods of wealth creation: agriculture, industry and information technology. As each new wealth creation method supersedes the previous one, more sophisticated accounting information is required. Information technology permits leading companies to become more competitive (Elliot, and Jacobson, 1991). Prior to the development of large-scale enterprises, if a measure of performance was needed, it was not uncommon for it to be arrived at by valuing assets and liabilities directly, computing the net asset position at two different dates and comparing one with the other to arrive at income. The emergence of large-scale enterprises in the nineteenth century, and the consequent separation of ownership and management control, created a need for financial

statements for the purpose of accountability in order to ensure that managers rendered a reliable report of their activities to owners. If a measure of performance was needed, accounting focused on tracking the cost of resources obtained and used by the enterprise and on matching cost with the revenue realized by the enterprise through time to arrive at income. A balance sheet did not purport to show the realizable value of assets. The results were not a measure of the increase or decrease in net assets in terms of purchasing power. These historical cost basis financial statements served the bygone industrial era well, but were becoming obsolete. Reliance on financial statements is insufficient for evaluating the ability of information-era enterprises to create future economic value.

THEORETICAL FRAMEWORK

An accounting for income is not merely a question of reporting in a different format but involves issues of recognition and measurement. The recognition, measurement and reporting of income depends on the construction of an accounting theory and is important for the use of accounting information. Two approaches in calculating income using the articulated accounting model (Belkaoui, A. R. 1994) are identified in Figure 2. There has generally been little discussion in accounting literature about the criteria needed in choosing the best approach which would serve the needs of the users of financial statements and guide standard-setters in formulating an accounting theory.

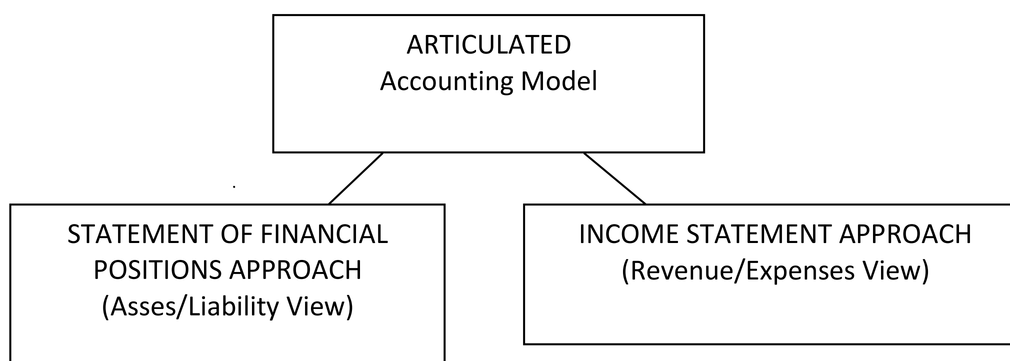

Figure 2: Articulated accounting model

According to the articulated accounting model, important aspects of traditional financial statements are basic elements to be included in the accounting concepts. Identifying and defining basic elements of the balance sheet and the income statement may be provided by both the balance sheet approach and the income statement approach. Balance sheet elements describe amounts of resources and claims to resources at a moment in time. Income statement elements describe amounts from value creation process throughout a given period.

Objectives of Financial Statements

Over decades professional bodies have studied the concept of decision usefulness. To understand this concept, professional bodies need to consider other theories from economics and finance. Accountants cannot make financial statements more useful until professional bodies know what usefulness means. Decision usefulness is contrasted with another view of the role of financial reporting, which is to report on management's success in managing the enterprise's resources. Aware of the importance of objectives, the professional bodies have made various attempts to formulate the objectives of financial statements. The Study Group on the Objectives of Financial Statements (the True blood Commission in April 1971) of the American Institute of Certified Public Accountants (AICPA) published it findings in 1973: The basic objective of financial statements is to provide information on which to base economic decisions (AICPA. 1973). First enunciated in 1966, and reinforced by the influential 1973 report of the True blood Commission, this simple observation has had major implication for accounting theory and practice. In particular, we must now pay much closer attention to users of financial statements and their decision needs since, under non-ideal conditions; it is not possible to read the value of the firm directly from the financial statements (Scott, 2003).

Two years later, a discussion paper issued by the UK Accounting Standards Steering Committee began with the words: Our basic approach has been that corporate reports should seek to satisfy, as far as possible, the information needs of users: they should be useful (Accounting Standards Steering Committee. 1975). The Financial Accounting Standards Board (FASB)1 began its efforts to develop a conceptual framework for financial accounting and reporting in November 1978 when it issued authoritative, broadly based guidelines spelling out the objectives of financial reporting in Statement of Financial Accounting Concepts No.1 (SFAC 1). The statement was not limited to the contents of financial statements: Financial reporting includes not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system, that is, information about an enterprise's resources, obligations, earnings, etc. The current Estonian Accounting Act (EAA) was established by legislation and is accompanied by guidelines from the Estonian Accounting Standards Board (Estonian GAAP). The purpose of this Act is to create the legal basis and establish general requirements for organizing accounting and reporting in the Republic of Estonia pursuant to internationally recognized accounting and reporting principles.

Statements of Financial Positions Approach

The question is not which of these two statements is more important, rather which statement should form the basis from which the others are derived. Historical cost basis accounting is an income statement approach. Under this approach unrealized increases in asset and liability values are not recognized and the balance sheet is derived from the income statement. When real world conditions are constantly changing, then the question is whether historical cost basis accounting provides sufficient information on which to base economic decisions for evaluating the enterprise's abilities to create future economic value. Present value accounting is a balance sheet approach. Under this approach increases or decreases in asset and liability values are recognized by discounting future cash flows and the income statement is derived from the balance sheet. Both the FASB's and IASB's conceptual frameworks are based on the balance sheet approach. David Solomons summed up several reasons for preferring a balance sheet approach (Solomons, 1995). Assets and changes in them are central to the existence and operations of business enterprises. Proponents of the matching view are forced to define revenues and expenses in terms of changes in assets and liabilities. Anthony defines revenues as "those additions to entity equity resulting from operating activities of the period that can be reliably measured" and he later says that "equities are thought of as claims against the assets (Anthony, 1983). The FASB's definition of revenues is unambiguous: "Revenues are inflows or other enhancements of assets of any entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. This is the fundamental reason for taking the balance sheet approach. If there is not a strict relationship between the process of income determination and changes in owner's equity, debits and credits are apt to creep into the income statement that do not represent real transactions or the effects on the enterprise of real events and conditions – items like charges for future maintenance, for example. This opens the way for income smoothing, which is probably why preparers tend to prefer the matching approach.

Economic versus Accounting Income

To understand the concepts of economic income and accounting income, professional bodies need to consider the concept of income. Figure 3 implies that income is a generic name.

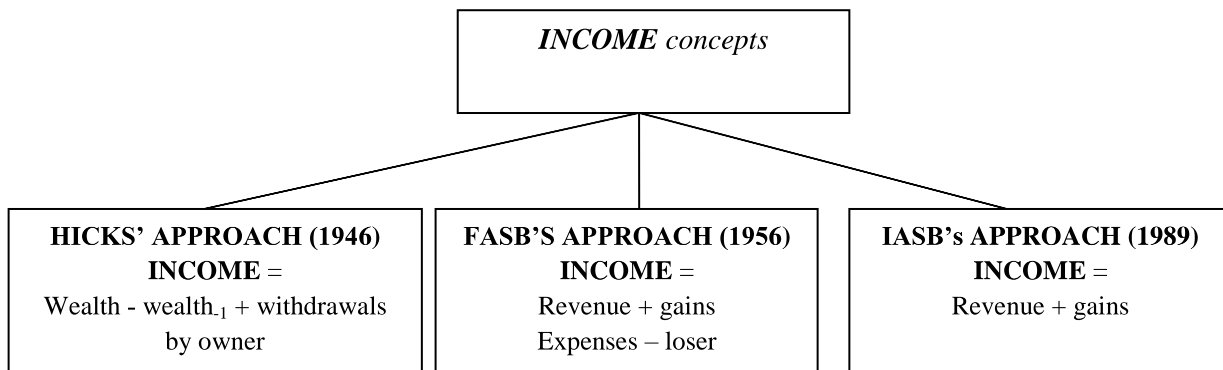

Figure 3: Comprehension of Income Concepts

According to Hicks' approach, income is the change in wealth. In the approach used by the FASB, income refers to the excess of revenues and gains over expenses and losses for a period. However, in the IASB's approach, income refers to both revenues and gains.

- **Hicks' approach** Income is the change in wealth adjusted for withdrawals by owners (Hicks, 1946). The following Equation 1 and Equation 2 illustrate the measurement of change in wealth: **change in wealth** = income - withdrawals by owners (1)

Equation 1: Change in wealth depends on measuring income and withdrawals by owners during the Period change in wealth = wealth - wealth-1 (2)

Equation 2:
Change in wealth depends on measuring wealth at the beginning and end of the period Both mathematical sentences have something in common on the left side. Simplifying wealth Equation 1 and Equation 2:

Income = withdrawals by owners + (wealth) – (wealth)-1 (3)

Equation 3: Economic Income
Economists have adopted a wealth maintenance concept. They measure income by the difference between wealth at two points in time. They subtract beginning wealth from ending wealth and adjust for any withdrawals by owners during the period. Economic income consists of withdrawals by owners, which is consumption, and change in owners' wealth, which is saving. Under the wealth maintenance concept, income is the maximum amount that can be consumed during a period and still leave the owners with the same amount of wealth at the end of the period as at the beginning. Hicks' classical definition states that enterprise can measure economic income, which is based on some

valuation for example historical cost, fair market value, or discounted future cash flows as a measure of increase or decrease in net wealth.
The author draws attention to the accounting of the off - balance - sheet assets which are vital to the information-era enterprise. Human resources, information systems, R&D play key roles in the net wealth of owners. For example, if the manager leaves the enterprise, the difficulty lies in the recognition and measurement of the gain or loss. The investor's ability to evaluate the qualitative factors for example decision-making ability of managers is as important as the investment decision itself. Hicks' wealth is determined with reference to the current market values of equity at the beginning and end of the period. Therefore, the economic income would fully incorporate market value changes in the determination of periodic return on an investment:

$$\text{Periodic return} = \text{dividend} + [(\text{market value})_t - (\text{market value})_{t-1}] \quad (4)$$

Equation 4: Financial return on an investment consists of dividend and change in market value
The periodic return shareholders get on an investment comes in two forms. First, shareholders may receive some cash from the enterprise during the year, called a dividend, which is a realized component of periodic return. In addition, market value changes of equity represent an unrealized component of periodic return. If shareholders sold the investment at the end of the period, both dividend and market value changes of equity are realized components of periodic return.

MATERIALS AND METHODS

For this study, the research design adopted was the survey research in which a sample is selected at random, amongst the population of the study. Questionnaires administer to each member of the group and oral interview is carried out. The research is based on data collected from Fidson Nigeria Plc, Ikorodu Road, Obanikoro, Lagos state. The population of the study was made up of the entire staff of FIDSON Nigeria Plc and Nestle Nigeria Plc; number's three thousand and fifteen (3015). This implies that both the staff and the managerial level of the organization formed the population of study. The population is so large that it was impossible to reach staff in FIDSON Nigeria Plc and Nestle Nigeria Plc. There is need to select a sample size. This was a representative of the elements of the population of interest.

SAMPLE/ SAMPLING TECHNIQUES

To ensure that returned questionnaires are sizeable, a targeted sample size was used. Thus, the research instrument was administered to fifty (50) respondents.

Sample Technique

The random sampling technique was used to select the staff. A questionnaire was given to respondents at random. For easy interpretation and conclusion, the questionnaire is divided into two sections. Section A is for bio-data of respondents while sections B consists of structured question of which respondents are to provide answers to.

Research Instrument

The use of questionnaires was adopted because it guarantees a higher level of anonymity of individuals. The questionnaires were delivered by hand and later collected at an agreed time. Primary data were collected from questionnaires while secondary data was obtained from journals, textbooks and other relevant publications.

Statistical Tools

A descriptive statistics and frequency distribution table was used in the analysis of data collated from the questionnaire which addresses the response of the respondents to the structured questions posed in the questionnaire. The use of descriptive statistics and frequency tables is to extract the opinion of majority of the respondents to the questions raised in the research work. Chi-square test of hypothesis was used to test the hypothesis earlier raised in the study. Chi-square tests for contingency tables are the applied statistical methods for determining whether two categorical measures are related. Expected frequencies are derived from the marginal frequencies.

These expected frequencies may be calculated from the formula:

$$X^2 = \sum \frac{(o-e)^2}{e}$$

Fe = is computed as $\frac{(nc)x(nr)}{n}$

Where:
O = observed frequency
E = expected frequency
N = number of respondents
C = number of columns
R = number of rows
Degree of freedom (df)
df = (r-1)(c-1)
Where: c = columns
r = rows

The more perfect the market the more useful market values will be in measuring income based on changes in the value of assets and liabilities.

	Observed N	Expected N	Residual
Strongly agree	12	10.5	1.5
Agree	9	10.5	-1.5
Total	21		

Test Statistics

	The more perfect the market the more useful market values will be in measuring income based on changes in the value of assets and liabilities.
Chi-Square	.429[a]
Df	1
Asymp. Sig.	.513

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 10.5.

A chi-square goodness of fit was calculated comparing the frequency of occurrence of each value on the impact of 360 degree feedback on the factors affecting choice of prevailing income measuring concepts among manufacturing companies a study of Fidson Nigeria Plc and Nestle Nigeria Plc. From the tested hypothesis, 360 degree feedback would make the market perfect and assets and liabilities will be easy to measure. It was hypothesized that each value occurs on equal number of times. A significant deviation from the hypothesized value was found (X^2= 80.400; P ɑ 0.000).

DISCUSSION OF FINDINGS

The respondents, to the questionnaire were more men (76.2%) than women, and single (23.8%) than married (76.2%). Almost two third of the respondents had B.Sc/HND (66.7%) than second degree (33.3%). Regarding fiscal year often attempts to follow natural business year cycle, 23.8% strongly agreed, 47.6% agreed, 9.5% were undecided, disagreed and strongly disagreed. Regarding accrual of accounting measures revenues as earned and expenses as incurred, strongly agreed (57.1%) and agreed (42.9%). Regarding revenue recognition normally occurs at the time goods are supplied or services rendered, 61.9% strongly agreed 33.3% agreed, 4.8% were undecided and 9.6% disagreed. Regarding assigning revenues and expenses to time period is pivotal in the determination of income, 38.1% strongly agreed, 33.3% agreed while 4.8% were undecided. Regarding recognize an item is to record it into the accounting books, 38.1% strongly agreed 47.6% agreed, 14.3% were undecided and 4.8% strongly disagreed.

CONCLUSIONS AND RECOMMENDATIONS

The evidence shows that the choice of accounting income concept as the prevailing income measurement concept is premised on historical cost accounting given its unconditional and long standing acceptance of this version by the accounting profession and the business world. This can be explained by the fact that its objectives verifiable, practical and easy to understand and avoid confusion. The concept of income measurement has always been an important point of interest to users of financial statement. However, historical cost principles should not be relied upon because of its difficulties in the different acceptable methods of computing cost. Also, the result is misleading of data to some users of financial accounting. In view of this, the economic income should be used as a prevailing income measurement by manufacturing company in a financial report as this will militate against the following:

a. Accounting income fails to recognize increase in value of asset held in a given period due to the application of the historical cost and realization principle.
b. Reliance on accounting income on historical cost principle make comparability difficult given the different acceptable methods of computing cost.
c. Reliance on the historical cost principle may give users impression that the balance sheet represent an approximation of value rather than merely a statement of unallocated cost balances.

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Reference to this paper should be made as follows: Ademola Emmanuel Akinyele *et al*, (2015), Factors affecting the Choice of Prevailing Income Measuring Concepts among Manufacturing Companies. *J. of Business and Organizational Development Vol. 7, No. 1, Pp. 56 – 67.*