ACCOUNTING CONCEPT OF INCOME

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The measurement of income occupies a central position in accounting. Income measurement is probably the most important objective and function of accounting, accounting concepts, principles and procedures used by a business enterprise. Generally speaking, income represent wealth increase and business success; the higher the income, the greater will be the success of a business enterprise. The following are some of the major areas where income information is practically useful:

1. **Income as a guide to dividend and retention policy:** Income information determines as to how much of a business enterprise's periodic income can be distributed to its owners and how much shall be retained to maintain or expand its activities. The income is the maximum amount, which can be distributed as dividends and retained for expansion. However, because of the difference in accrual accounting and cash accounting income, a firm may not distribute the total recognised income as dividends. Liquidity and investment prospects are necessary variables for the determination of dividend policy.
2. **Income as a measure of managerial efficiency:** Income is regarded as an indicator of management's effectiveness in utilizing the resources belonging to the external users. Income tends to provide the basic standard by which success is measured. Thus, income is a measure is a measure to evaluate the quality of management's policy making, decision making, and controlling activities. The True blood Committee Report comments: "An objective of financial statements is to supply information useful in judging management's ability to utilize enterprise recourses effectively in achieving the primary enterprise goal."
3. **Income as guide to future predictions**: Income helps in predicting the future income and future economic events of business enterprise as current income acts to influence future expectations. It helps in evaluating the worth of future investments while making investment decisions.
4. **Income as a means of determining tax:** Income figure determines the tax liability of a business enterprise. How tax is determined is important to

management and investors both. The taxation authorities generally accept accounting income as a basis of assessing the tax.

5. **Income as a guide to credit worthiness and other economic decisions:** Credit grantors- individuals and institutional both-require evidence of sound financial status before advancing loans to business enterprises. Income-current and future both-is a relevant data to determine a concern's ability to repay loans and other liabilities at maturity. Besides, income figure is useful in other decision areas also such as pricing, collective bargaining, governmental, social and economic regulation and policies.

Different Concepts of Income Measurement

Measurement of income, as stated earlier, is probably the most important objective and function of accounting, accounting concepts, principles and procedures used by a business enterprise. Measuring periodic income of a business has, therefore, been debatable issue among the theorists, researchers, accounting bodies, accounting educators and practitioners. Accordingly, many concepts and approaches have emerged which aim to determine net income: of a business for an accounting period. The different concepts of income measurement have led to different types of income, which can be measured for a business enterprise.

The different concepts of income measurement or different types of income are as follows:

(1) Accounting Income (or Business Income or Accounting concept of Income).

(2) Economic Income (or Economic Concept of Income).

(3) Capital Maintenance Income (or Capital Maintenance Concept of Income).

Besides the above concepts or approaches, there are other income concepts such as current value income comprising different valuation bases like replacement costs, current entry price, net realisable value or current exit price etc.

1. **Accounting Income**

Accounting income, often referred to as business income or conventional income is measured in accordance with generally accepted accounting principles. The profit and loss account or income statement determines the net income or operating performance of a business enterprise for some particular period of time. Income is determined by following income statement approach, i.e., by comparing sales revenue and costs related to the sales revenue.

Net income is determined as follows:

Revenue - Expenses =Net Income

The net income defined as the difference between revenue and expenses determine the business income of an enterprise. Under the income statements approach, expenses are matched with the revenues and the income statement is the most significant financial statement to measure income of a business enterprise. Thus, business income of an entity represents the difference between the realized revenues arising from the transactions of the period and the corresponding historical costs.

Accounting income is the increase in the resources of a business (or other) entity, which results from the operations of the enterprise. In other words, accounting income is the net increase in owner's equity resulting from the operations of a company. It should be distinguished from the capital contributed to the entity. Income is a net concept; it consists of the revenue generated by the business, less losses expires costs that contribute to the production of revenue.

Accounting income is measured in terms of transactions, which the business enterprise enters into with third parties in its operational activities. The transactions relate mainly to revenues received from the sale of goods and/or services, and the various costs incurred in achieving these sales.

Procedure of Computing Accounting Income

The procedure for computing accounting income may be summarized as follows:

(i) **Defining the particular accounting period:** Accounting income refers to the financial performance of the firm for a definite period. The commonly accepted accounting period is either the calendar or natural business year. It should be recognised, however, that income can be determined precisely only at the termination of the entity's life. The preparation of annual financial statements represents somewhat of a compromise between the greater accuracy achieved by lengthening the accounting period and the greater need for frequent operating reports.

(ii) **Identifying revenues of the accounting period selected**: Accounting income requires the definition, measurement, and recognition of revenues. In general, realization principle is used for recognition of revenues and consequently for the recognition of income. Revenue is the aggregate of value received in exchange for the goods and services of and enterprise. Sales of goods are the commonest from of revenue. In accordance with realization principle, the accountant does not consider changes in value until they have crystallized following a transaction. The realization principle is not applicable in case of unrealized losses, which are recognised, measured, accounted for and subsequently reported prior to realization. There are some other instances where realization principle is ignored and unrealized income is recognised. Some such examples are valuation of properties, long-term contract business.

(iii) **Identifying costs corresponding to revenues earned:** Accounting concept of income is based on the historical concept. Income for an accounting period considers only those costs, which have become expenses, i.e., those costs which have been applied against revenue. Those costs, which have not, yet expired or been utilized in connection with the realization of revenue are not the costs to be used in computing accounting income. Such costs are assets and appear on the balance sheet. Prepaid expenses, inventories, and plant thus represent examples of deferred unallocated costs.

(iv) **Matching Principle:** Traditional accounting income is expressed as a matching of revenue and expenditure transaction, and results in a series of residues for balances sheet purposes. Matching principle requires that revenues which are recognized through the application of the realization principle are then related to (or matched with) relevant and appropriate historical costs. The cost elements regarded as having expired service potential are allocated or matched against relevant revenues.

Arguments in Favour of Accounting Concept of Income

(1) Accounting income is very useful in judging the past performance and decisions of management. Also it is useful for control purposes and for making management accountable to shareholders for the use of resources entrusted to it.

(2) Another argument in favour of historical cost-based income is that it is based on actual and factual transactions which may be verified. Advocates of accounting income contend that the function of accounting is to report fact rather than value. Therefore, accounting income is measured and reported objectively and it is consequently verifiable.

(3) Accounting concept of income has the benefit of a sound, factual and objective transaction base. Accounting income has stood the test of time and therefore is used by the universal accounting community.

(4) In times of inflation, which is now a usual feature, alternative income measurement approaches as compared to accounting income could give lower operating income, lower rates of return which could lower share prices of a business firm.

(5) Income based on historical cost is the least costly because it minimizes potential doubts about information reliability, and effort in preparing the information.

Limitations of Accounting Income

There are certain limitations of the accounting income as given under:-

(i) Firstly, the traditional accounting income is based upon historical cost principle and conventions which may be severally criticized, e.g., lack of useful contemporary valuations in times of price level changes, inconsistencies in the measurement of periodic income of different firms and even between different years for the same firm due to generally accepted accounting principles.

(ii) Secondly, validity of business income depends on measurement process and the measurement process depends on the soundness of the judgments involved in revenue recognition and cost allocation and related matching between the two. There is a great deal of flexibility and subjectivity involved in assigning cost and revenue items to specific time periods and using matching concept.

(iii) Thirdly, the historical cost concept and realization principle conceal essential information about unrealized income since it is not reported under historical accounting. Unrealized income results from holding assets, which should be reported to provide useful informant about business and its profitability and financial position.

Components of Accounting Income

A profit and loss account or income statement, as stated earlier, determine the net income or business income of a business enterprise and displays revenues and expenses of the enterprises for a specified period.

Therefore, business income has the following two major components or elements:

(1) Revenue

(2) Expenses

Besides the revenues and expenses, gains and losses are also considered while determining business income or net profit of an enterprise.

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