

THE ACCOUNTING PROFIT – A MEASURE OF THE PERFORMANCE OF THE BUSINESS ENTITY

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Abstract:

Profit is believed to be the main indicator for measuring the performance of the business entity, but performance cannot come down to the mere identification of the economic profit. Profit is a value that has been created for the business entity while performance is a reference term used by the managers and employees of a company. Economic performance means that the attained results should exceed the defined objectives, the competition and the results arrived at during the previous years. The first stage of our research will focus on ascertaining whether the performance of the business entity is influenced by the moment when the economic profit is recognized. A second stage will comprise an analysis of the effects of recognising R&D costs as assets on the economic profit and on the performance of the business entity. The third stage of our research consists in proving that, while the net worth can be altered through creative accounting techniques, the economic performance stays the same. The importance of the going concern, prudence and time period principles for the measurement of the accounting profit and for the economic performance of the company is highlighted towards the end of the paper.

Key words: economic profit, economic performance, incomes, costs, accounting prudence.

JEL classification: M41

INTRODUCTION

Profit is a highly debated economic concept and this is one of the reasons why the purpose of the following analysis is to highlight the link between the economic profit and the economic performance of the company. There have been numerous attempts and methods to define and explain the notion of profit. Thus, profit can be defined “in terms of the positive difference between the revenue gained after the sale of the goods produced by a business entity and the costs incurred during production, understood as a measure of economic efficiency”(Popa, 2006, 803). Broadly speaking, profit is the monetary benefit or advantage gained after performing an economic activity. The business entity cannot exist and cannot sustain its further development if it doesn't recover its costs and gain surplus revenue. As a result of the economic activity, seen as a gap between the revenues and the expenditures of a business entity, all the lucrative activities performed in an economic system are believed to have profit as a main objective.

Unlike economic revenue, the accounting profit belongs to a business entity and its purpose is to measure the subsequent financial performance of the enterprise. The accounting profit is periodically calculated as a surplus of the company's business cycle. The calculation of the accounting profit reveals that it measures the past economic performance of the company throughout a specific time interval. The accounting profit can also fill other purposes in the economic activity of a company: (Jianu, 2007, 57) guidance for the dividend and earning policy of the entity; forecasting method for future revenue in investment and disinvestment decision making processes; method used for assessing the management's ability to run the business; method used for assessing the value of the decisions made by other parties related to the specific business unit; management instrument in various key areas inside or outside the entity (pricing policy, salary negotiation, credibility to borrowers, regulations).

Profit is “an expression of the rationality of the economic performance”(Mateș, 2010, 255). It encompasses the results of a business entity and dictates its further continuity and development.

Profit also mirrors the benefit gained after performing an economic activity and is the objective motivation of entrepreneurs and owners of capital. Profit stimulates initiative, risk acceptance and fuels the efforts to increase the rationality or the efficiency of the economic activity.

The accounting profit is the main indicator for measuring the financial performance of the enterprise, but accounting profit should not be mistaken for the concept of performance. Performance is defined as the competitive spirit of a specific business entity that consolidates its lasting presence on the market. Dider Noye (Noye, 2002, 6) believes that performance consists in reaching the goals that have been set in compliance with the assumed position of the company. Performance is “an outstanding result reached in the field of management, business and trade, conveying competitiveness, efficiency and effectiveness to the organisation and to its methodological and structural elements.” (Verboncu, 2005, 64).

The performance of the company cannot be reduced to the mere identification of the economic profit. On the contrary, performance is the result of the comparison between the obtained results and the outlined objectives.

REVENUE RECOGNITION AND THE PERFORMANCE OF THE BUSINESS ENTITY

The correlation between the economic profit and the performance of the business entity will be outlined by analysing the moment when the company recognises the revenue in its books. “By applying the accounting prudence principle, the replacement of the cost with the sale price can be recognised either when the cash is collected (maximum prudence), at the time of delivery (average prudence), or at the completion of production (minimum prudence). Professionals have agreed on the recognition of revenue at the time of delivery.” (Jianu, 2007, 52).

Example: Consider a business entity that manufactured finished products during the year N, with a production cost of 2.000 lei. The products are sold in the year N+1 at a sale price of 2.200 lei, and the cash is collected in the year N+2. Our goal is to analyse how the productivity of the business entity is influenced by revenue recognition during the period N – N+2. Tables 1, 2 and 3 show the expenditure, the income and the revenue for the three accounting periods, for different methods of revenue recognition.

Table no. 1: Revenue recognition at the completion of production

Year	N	N+1	N+2
Incomes	2 200	2 200 – 2 200	0
Costs	2 000	0	0
Profit	200	0	0

The income accrued during the year N, amounting to 2.200 lei accounts for the revenue related to the inventory costs, recorded when the finished products were completed. The expenditure amounting to 2.000 lei stands for input (raw materials, salaries, depreciation, etc.) used for acquiring the finished products during the fiscal year N.

Note that no expenses are recorded in accounting during the year N+1, but the income amounts to 0, since the revenue acquired from the sale of the finished products and amounting to 2.200 lei equals the income related to the cost of inventory which was recorded in the ending inventory.

During the year N+2, records are kept only for the debt resulted from the sale of the finished products and, therefore, no revenues or expenses are recorded.

Table no. 2: Revenue recognition at the time of delivery

Year	N	N+1	N+2
Incomes	2 000	2 200 – 2 000	0
Costs	2 000	0	0
Profit	0	200	0

Revenue amounts to 0 during the year N, since the income resulted from the cost of inventory is recorded as production costs which incorporate all the expenses (raw materials, salaries, depreciation, etc.)

The revenue amounting to 200 lei for the year N+1 accounts for the difference between the income resulted from the sale of the finished products and the income related to the cost of inventory.

The recording of the payment collected from the sale of the finished products during the year N+2 does not generate expenses or revenue and, therefore, the revenue amounts to 0.

Table no. 3: Revenue recognition when the cash is collected

Year	N	N+1	N+2
Incomes	0	0	2 200
Costs	0	0	2 000
Profit	0	0	200

In the case shown in table 3, the expenses related to the manufacture of the finished products are recognised in the books as related to the N+2 accounting period, even though they are expended during the N accounting period. The current income from the sale of the finished products is recognised at the time when the cash is collected and changes the revenue recorded during the N+2 accounting period.

At the end of the year N, the products being processed are recorded as costs related to the production of the finished items. The finished products are recorded at production cost during the year N+1, while the items being processed are recorded in the ending inventory. At the time when the finished products are sold in the year N, a prepaid income of 2 200 lei is recorded, while the ending inventory of the sold items generates a prepaid expense of 2 000 lei.

In the above presented example, the operating cycle (purchase – production – sale – payment) stretches throughout three accounting periods. As seen in Tables 1, 2 and 3, the accrued income for the three years is the same, regardless of the moment of revenue recognition. Similarly, note that when the operating cycle extends over several accounting periods, the accounting profit of each period differs, depending on the moment of revenue recognition.

Therefore, the question to be asked is: is the evolution of the performance of the enterprise similar to the evolution of the revenue throughout the three years of the operating cycle?

The answer to this question must take into account the fact that performance is not related to a single accounting period but covers the evolution in time of the business entity throughout a lengthy interval or during a period that can be forecasted. Thus, regardless of the methods applied, performance is the same in any of the three accounting periods, even if the accounting profit is different.

The above presented example serves as proof of the fact that performance must not be mistaken for revenue, as the latter is an indicator of performance. If economic income is the difference between current revenues and current expenses, performance describes a competitive state that ensures the long-lasting presence of the business entity on the market.

THE IMPACT OF RECOGNISING R&D COSTS AS ASSETS ON THE ECONOMIC INCOME AND ON THE PERFORMANCE OF THE ENTERPRISE

Since R&D expenses are defined as intangible assets in the International Financial Reporting Standards (IFRS), the US GAAP provides that R&D expenses should be carried out in the books as expenses.

In order to observe the impact of recognising R&D costs as assets, consider the following *example*:

A business entity records R&D costs of 4.000 lei during the year N for the development of a new product. The life cycle of the new product amounts to 4 years. The new product brings in cash

flows of 1.800 lei/year, starting with the year after the R&D costs have been expended. The production costs are estimated at 200 lei/year.

According to the IFRS standards, the amortisation period of the R&D costs for the above presented example is of four years, if we use the linear method. Table 4 outlines the revenue and the performance of the business entity for the four years that cover the life cycle of the new product.

Table no. 4: The revenue and the performance of the enterprise when R&D costs are recognised as assets

Element	Anul N+1	Anul N+2	Anul N+3	Anul N+4
Sales incomes	1 800	1 800	1 800	1 800
Production costs	200	200	200	200
Costs related to the amortisation of R&D costs	1 000	1 000	1 000	1 000
Accounting result	600	600	600	600
Performance of the business entity	2 400			

Table 5 shows the impact that the failure to recognise R&D costs as assets may have on the accounting profit and on the performance of the enterprise:

Table no. 5: The accounting profit and the performance of the enterprise when R&D costs are not recognised as assets

Element	Anul N	Anul N+1	Anul N+2	Anul N+3	Anul N+4
Sales incomes	0	1 800	1 800	1 800	1 800
Production costs	0	200	200	200	200
Costs related to the amortisation of R&D costs	4 000	0	0	0	0
Accounting result	- 4 000	1 600	1 600	1 600	1 600
Performance of the business entity	2 400				

An analysis of the data shown in tables no. 4 and 5 reveals that the accounting profit of each accounting period differs significantly depending on whether the R&D costs are recognised as assets.

However, the performance of the business entity is the same for the two cases, as it allows the business entity to maintain its long lasting position on the market, thus signalling the fact that performance is achieved in time and not at a specific moment.

CREATIVE ACCOUNTING AND THE ADJUSTMENT OF THE ACCOUNTING PROFIT

Creative accounting allows for the accounting profit of a business entity to be significantly adjusted. Thus, if the employment of one technique leads to a certain result, which may currently be higher or lower, the situation could be reversed in the future. The overall performance of the enterprise is the same. In order to prove this point, consider the following example:

At the beginning of the year N, a business entity holds raw materials inventories of 40 u.a. (unit of account) valued at 20 lei/u.a.. The business entity purchases raw materials during the year N as follows: 70 u.a. x 22 lei/u.m. and 30 u.a. x 28 lei/u.a. At the end of the N accounting period, the company spends 60 u.a., and the inventory of 80 u.a. will be spent during the year N+1. The revenue accrued by the business unit amounts to 2.000 lei in the year N and 2.400 lei in N+1. We will thus calculate the income accrued during the accounting periods N and N+1, the total income of the two accounting periods, and the performance of the business entity under the following circumstances:

- a) the company uses the WAC (weighted average cost) method for the ending inventory;

b) the company uses the FIFO method to calculate the ending inventory.

Table no. 6: Effects of the methods used to calculate inventory on the accounting profit

Element	METODA CMP	METODA FIFO
Revenue for the year N	2 000	2 000
Costs for the year N	1 362,86 (60 x 22,7142)	1 240 (40 x 20 + 20 x 22)
Accounting profit for the N accounting period	637,14	760
Revenue for the year N	2 400	2 400
Costs for the year N+1	1 817,14 (80 x 22,7142)	1940 (50 x 22 + 30 x 28)
Revenue for the year N+1	582,86	460
Performance of the enterprise	1220	1220

Note that, when the FIFO, rather than the WAC, method is applied, the business entity accrues a higher income during the year N. A higher income is recorded during the year N+1, after applying the WAC method. The explanation lies with the fact that, according to the FIFO method, the oldest inventory items are sold first. If this method is applied as prices are rising, the inventory costs are recorded at their lowest value, and the ending inventory is recorded with its most recent value, which is also the highest.

Even though the accounting profit accrued during each of the two accounting periods can be influenced by the chosen calculation method, the performance of the business unit for the two years under analysis is the same, regardless of the methods used to calculate or value stocks.

According to the IASB, the accounting profit should not be used in assessing the performance of the enterprise. The IASB general framework suggests switching from the accounting profit to a comprehensive income. Thus, the past and present accounting profit has been gradually replaced and the focus has switched to the concept of performance that defines the future prospects of the business entity.

THE GOING CONCERN, PRUDENCE AND MATCHING PRINCIPLES – CONCEPTS THE INFLUENCE THE ACCOUNTING PROFIT AND THE PERFORMANCE OF THE BUSINESS UNIT

The going concern principle starts from the assumption that the business will continue its activity indefinitely, without becoming insolvent or significantly slowing down its operations. The preparation of the annual financial statements will observe the going concern principle. If the activity of the enterprise is interrupted during the accounting period, the financial statements will be prepared at that time.

The creditors of a company and, generally, any prospective investor, are interested in the continuity of the business they are interested in.

If the managers of a business entity have become aware of certain risks related to certain events that may lead to the inability of the business to function normally, these elements must be presented in the notes to the financial statements. If the annual financial statements are not prepared in compliance with the going concern principle, this information must be disclosed and accompanied by explanatory notes about the way the statements were prepared and the reasons behind the decision according to which the business unit can no longer continue its activity. The events or circumstances that must be accompanied by additional information can also be presented after the completion of the balance sheet.

The lack of continuity is the exception in the activity of any business and is followed by dissolution and subsequent liquidation. It also requires a revision of the employed accounting methods that have considerably influenced the financial position, the performance and the revenue of the business. The fiscal outlook is also altered, as the taxation criteria will be altered accordingly.

Certain accounting methods are applied under the continuity assumption, but they will have to be altered if the business is not regarded as being continuous. For instance, a fixed asset will be recorded in the financial statements at its net book value which equals the initial value less depreciation. This statement is only valid if the business will continue to function for a period that is at least equal to the life cycle of that particular asset. If the business ceases its activities, it will go into liquidation, and the calculation of the fixed assets will take into account their liquidation value which equals the price that may be collected upon the immediate sale of the item. In practice, the liquidation value is often lower than the book value. The differences between the value of the assets when the business is continuous and the value of the same assets when activities lack continuity will alter the taxation criteria. Therefore, we can argue that the effects of the going concern principle on the accounting profit are quite significant and rather visible when the business no longer benefits from adequate circumstances to continue its activities.

The assessment of the economic performance of the business does not rely only on the past and present information. The future plays an important part in assessing the company's ability to perform efficiently and no decision can be made about the future unless the business is assumed to continue indefinitely.

The prudence principle urges entrepreneurs to avoid overestimating the chances of their business, to be cautious and to promote a pessimistic outlook in the assessments, choices and estimations they need to perform. When preparing the annual financial statements, the evaluation must be performed on a prudent basis and, particularly:

- include in the profit and loss account only the accounting profit that has been acquired by the time the balance sheet is completed;
- take into account all the debts that have occurred throughout the current or the previous accounting period, even if they only become visible between the time the balance sheet is prepared and the time it is completed;
- take into account all foreseeable debts and potential losses that have occurred during the current or the previous accounting period, even if they only become visible between the time the balance sheet is prepared and the time it is completed; therefore, any possible provisions are also being considered, as well as the debts resulting from contract terms;
- take into account all depreciations, regardless of whether the accounting period results in profit or losses. The adjustments for depreciation or loss in value must be recorded in the expense accounts, regardless of their impact on the profit and loss account.

As a consequence of the prudence principle, assets and revenues should not be overstated while liabilities and expenses should not be understated. However, prudence does not allow, for instance, the recording of excessive provisions, the deliberate understatement of assets or revenues, or the deliberate overstatement of liabilities or expenses, since the financial statements would no longer be unbiased and would lose credibility.

An analysis of the provisions of the prudence principle in terms of profit, debts and depreciation will reveal that the fiscal consequences are quite obvious. The recognition of the expenses is not conditioned by their payment, and the accountant must take into account all depreciations, even if they are only probable. Thus, the costs recorded for probable risks or depreciations will diminish the accounting profit and, implicitly, the corporation tax. At the same time, the asymmetry that defines accounting prudence will entail the addition of the probable income to the same accounting profit. For instance, the revenue from the sale of commodities is recorded only after the sale has been completed. Even if we know that the sale price of the goods we still have in the warehouse doesn't exceed the purchase price, the related revenue is only recorded in the books when those goods have been sold.

The asymmetry that characterizes accounting prudence is quite visible in the case of the differences found during inventory. The positive variance (fair value that exceeds the monetary value) found when the stocks are being evaluated will generate probable revenues or gains that are not recorded in accounting and do not affect the taxable income. This positive variance can only be taken into account when the stored goods have actually been sold. On the other hand, the negative

variance (fair value is below monetary value) is recorded in the books as a depreciation expense that will diminish the accounting profit of the business and, subsequently, the taxable income.

Confirmed liabilities are recorded in accounting even if their certainty is confirmed shortly after the end of the accounting period, provided that the main event that generated them had occurred prior to this date. One example in this respect is the receipt of goods and services whose invoices still hadn't been received by the end of the accounting period. The liability to the supplier exists and is recognised as such, and the subsequent arrival of the invoice will confirm it.

Predictable liabilities and potential losses often occur in the case of provisions. For instance, the following accounting argument can be applied to a lawsuit involving the business at the end of the accounting period:

- if the lawsuit is believed to be solved in favour of the business, there will be a probable revenue that the prudence principle will prevent the entity from taking into account;
- if the lawsuit is likely to be lost, then the probable loss (the costs) will be recognised immediately.

There is an apparent asymmetry in the manner of calculating the probable gains as opposed to the accounting treatment of the probable losses. Therefore, we can argue that the inclusion of the potential losses and the exclusion of the potential gains will prevent a rational assessment of the result and, implicitly, of the economic performance of the business.

The matching principle requires the specific timely recording of the expenses as they are incurred and of the revenues as they are earned, as well as their recognition in the financial statements of their specific accounting period. The expenses incurred during the current accounting period are recorded in the same accounting period, even if their actual payment will be made during future accounting periods. Accordingly, the revenue generated during the current accounting period will be recorded in the financial statements of this specific period, even if their actual collection will occur during a future accounting period.

The matching principle requires that the revenue or the expenses should be recognised and matched with the costs or the efforts that have generated them. In other words, the revenues and the costs are correlated, as the efforts are set against the effects they generate.

We will further detail several cases that prove the financial and the fiscal consequences of the matching principle.

A first case focuses on the fact that the observance of the matching principle enables the identification in the revenue accounts of those debts that have not been accompanied by an invoice and the presence of liabilities that have not been accompanied by an invoice in the expenses accounts. Thus, the accounts 418 "Customers – invoices to be issued" and 408 "Suppliers – invoices to be received" will be used.

A second case emphasizes the accounting use of accrued expenses and deferred income that do not influence the financial aspects of the accounting period when they were recorded, but the results of future accounting periods. For instance, if in December 2011, a company collects the rent due for a commercial space let for a year (January 1st 2012 – December 31st 2012), the cash collected in 2011 is not recorded as current revenue but as a deferred income that will be transferred in instalments to the revenues earned in 2012 for each month. This will also be the case with accrued expenses. If a company pays a subscription for the following year (2012) in December 2011, the cash spent in December 2011 is not an expense recorded for that month but will be recorded as an accrued expense that will be transferred in instalments to the related expense accounts of each separate month of the year 2012.

The third situation concerns the observance of the matching principle in accrual accounting. This particular situation requires a precise delineation of accrual accounting from cash accounting. Certified natural persons can keep a type of cash accounting to record the value of the cash collected or expended. In this type of accounting, expenses are recognized when the payments are made, while revenues occur when cash is collected. Thus, the assets consist in the existing available items, while liabilities consist in the available monetary capital. Therefore, the accounting profit of

the accounting period will result from the difference between the cash received and the cash paid out throughout the period under consideration.

Apart from available assets, accrual accounting “also includes debts and other less liquid assets in the itemized assets column and, apart from monetary capital, also takes liabilities into account in the liabilities column. Therefore, the accounting profit will be defined in terms of expenses and revenues, the former consisting in asset contraction and debt augmentation, while the latter will consist in asset augmentation and debt contraction.” (Feleagă, 2005, 72). The present economic circumstances demand the employment of accrual accounting instead of cash accounting. We can bring forward two arguments to support this statement. Firstly, a business entity cannot rely only on their actual available cash, but often has to develop its activities by relying on the lending mechanisms. Secondly, accrual accounting is the only such treatment that can provide information on the future treasury flows.

We can thus wonder why is the sale of goods always followed by the ending inventory during the same month. The answer is provided by the correlation of the revenues with the expenses as a consequence of applying the matching principle in accrual accounting. The purchase of goods doesn't have immediate and direct effects on the accounting profit and the financial result since the business does not record either costs or revenues, and the owners' equity doesn't change. The payment of the purchased goods does not entail the recording of an expense in accounting because if the liability to the supplier disappears, so do the available liquidities of the company.

However, the business does not become poorer just because it still has the goods it had previously bought. When the goods are sold, the business will record revenue that will equal the sale price without VAT and, during the same inventory; the business will record the expense that equals the initial value of the goods sold. The payment of the sold items is often deferred and it will be recorded as a debt. The subsequent payment of this debt will not generate revenue but an increase of liquidities earned in the place of this debt.

The correlation of the revenues with the expenses that is derived from the matching principle and from accrual accounting will enable us to find the answer to the following two questions (Istrate, 2009, 137): When do raw materials influence the accounting profit? When do tangible and intangible assets influence the accounting profit?

The costs or expenses related to raw materials are recognized at the sale of the finished products whose cost incorporates that particular raw material. There are, however, exceptions to this rule: if the raw material is damaged, somehow disappears or depreciates, the expense will then be emphasized immediately after the event, regardless of whether or not it generated any revenue.

From an accounting standpoint, depreciation is an expense in the case of tangible assets, but its effect on the accounting profit is not necessarily visible at the exact moment when the depreciation has been recorded. The depreciation of the tangibles that are directly involved in the production of finished goods will influence the accounting profit at the time when the products whose production cost incorporates that particular depreciation are sold. In the case of those tangibles that are not directly involved in the production of goods and services, the depreciation costs influence the accounting profit at the time they are recorded, as this expense is not included in the production cost.

The matching principle is the reason why the financial result and the accounting profit have been separated, as a periodical reporting was necessary. Thus, if the employment of one method leads to a certain result, which may be higher or lower at present, the situation will certainly be reversed in the future and the overall economic performance will stay the same.

The various methods that generate different results do not influence the performance of the enterprise but the qualitative aspect of the accounting information in terms of comparison. The comparability of the accounting information could be made possible by employing a single method for solving an issue.

CONCLUSIONS

The performance of the business unit cannot be associated with the accounting profit, but with a comprehensive income that is superior to what had been achieved in a previous time period and higher than what the competition has earned. Performance is not a mere confirmation of the accounting profit; it is the result of a comparison between the earnings and the objectives. Therefore, performance is always the result of a comparison.

The economic performance of a business entity entails competitiveness, competitive advantage, efficiency and effectiveness. An efficient business conveys value for equity investors, meets the needs of its clients, takes into account the opinions of its employees and preserves the natural environment.

The accounting profit is calculated at the end of each accounting period, while economic performance is achieved in time and not at one single moment. The replacement of the accounting method used by the business unit influences the accounting profit, but not the overall performance of the business.

Performance can be assessed if the business is believed to continue indefinitely into the future. Note that accounting prudence discourages the rational assessment of the accounting profit and, implicitly, of the economic performance. The matching principle applied throughout the accounting period and the presence of accrual accounting can generate several accounting and financial consequences.

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