FINANCIAL PERFORMANCE MEASUREMENT THROUGH PROFIT AND LOSS ACCOUNT. CONVERGENCES AND DIVERGENCES.

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ABSTRACT: *Performance is a priority objective of any business and performance information is relevant to a wide variety of users of financial information. Most times the performance of the company is valued on the basis of the result account, "profits are often used as a measure of performance or as a reference for other indicators".*

KEYWORDS: financial statements, performance, profit and loss account, accounting standards, result.

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1. INTRODUCTION

The main objective of financial statements is that of providing useful information to investors regarding the performances of an entity. Although information from the financial statements refers to past performances, they are used by investors to make projections of future performances. In the financial statements, performances are measured through the net result and its components, which are shown in the result account. The result account offers information referring to a certain period of time. Main weaknesses of the result account are considered to be its periodic nature and the estimations it involves (the ability or the inability of the company to make this estimations reflects in the accuracy with which performances are measured). For a long period of time, performance was measured by net income. In recent years, in addition, performance has been represented through the economic result, which includes all equity changes taking place during the period, except those with owners. A long period of time, users of financial statements have limited their consultation to the profit and loss account in order to find out the accounting result, considered the most important measuring indicator for the economic entity's performance. On the same path lies and economic theory, stating that the primary purpose of economic activity is maximizing profits. But the freedom of choosing the accounting policies by companies that leads to an increase or a decrease of income, is one of the major information gaps of the profit and loss account.

Profit and loss account is the financial statement which measures the success or performance of the entity's activity, for a given period.

In what concerns the performance observation area through the results account, two opposable trends have been outlined:

- Some defend an **extended definition** (all-inclusive concept),
- Others prefer a more restrictive concept of result (current operating concept).

According to the "all inclusive concept", the result includes all the elements that lead to increase or decrease in equity, excluding the distribution of dividends and capital drops.

Partisans of the "current operating concept" support only the inclusion into the result account of the consequences of ordinary, normal operations of the current period. Specific items of exploitation are considered routine operations, allowing **predictions of future performance** and **comparing such performance** in space and time. This concept corresponds to the priority given to the results account. The supporters of "**current operating concept**" agree to the idea of performance evaluation through the results account, sending to the balance unrepresentative elements of performance. Company performance is reflected by the **results account**. But of the results account gives an incomplete picture of performance when it is not analyzed with a **balance sheet** and a **representation of the changes in the financial position of the company**.

2. THE AMERICAN ACCOUNTING SYSTEM AND THE PROFIT AND LOSS ACCOUNT

Introducing the representative accounting systems begins with the United States. Not because of a particular fascination or a certain complex related to the "American myth". Americans have become the "masters" of accounting conceptualization. They are the first to create the "conceptual frameworks". Accounting principles have reached a high degree of refinement, both in the theoretical aspect and the practical applicability. Development of U.S. accounting standards is done by reference to generally accepted accounting principles. In the U.S. accounting there is no separate standard which includes provisions related to the content and presentation of the results account. Moreover, the format of this financial statement is not standardized, accounts creators being bound to respect a set of general rules found particularly in the standards.

In the U.S. accounting, profit or loss account is shown in portrait format (list). The basic structure covers revenues and expenses. If revenues are greater than expenses the activity leads to profit. Otherwise the work ends in loss.

The classification of expenses is made according to their destination or company functions.

The American “Profit and loss” account distinguishes the following functions:

- Production function, through the cost of sold goods;
- Sales function, through selling expenses;
- Administrative function, through the general and administrative expenses;
- Financial function, in particular with interest expense.

Extraordinary items appear separately in the document structure. The size of payable tax is divided into two categories:

- Tax on current profit;
- Tax on exceptional items.

For joint stock companies, in the bottom of the account sheet it is mentioned the benefit per share.

2.1. Features of the american profit and loss account

Although there is not a general rule for presenting the profit and loss, the U.S. standardization body has provided three sets of accounting rules of presentation on the following elements:

- presentation of extraordinary items;
- scope of method change;
- transfer of activity domain.

Unlike many countries of continental Europe the American concept of profit and loss account reveals neither “value added” nor “activity production”.

The fundamental concept is that of the cost of sold goods without distinguishing between the sold goods and sold production. The corresponding item “net sales” does not specify whether it refers to the income from the sale of goods or the sold production. Unlike the opinion of continental Europe, in the U.S. only the sold production is considered to be a measure of the product created by a producer. This is the reason why the added value lacks from the account’s structure. From the point of view of the procedure, in order to make a profit and loss sheet, American accountants use the information generated by analytical accounting, i.e. the methods of identification and calculation of direct and indirect expenses that allow the calculation (in producer companies) of “cost of sold goods”. Although operating costs are grouped analytically according to the functions in the company, U.S. accounting allows the identification of the three categories of expenses and revenue: (a) operating revenues and expenses, (b) financial income and expenses, (c) extraordinary income and expenses. Net sales are obtained by deducting the items of trade discounts from gross sales. Cost of sold goods is calculated differently if the company is commercial or industrial.

In the case of commercial activity:

Cost of sold goods = Initial goods stock + Period purchase - Final goods stock

In the case of industrial activity:

Products cost	=	initial stock of finished products	+	production cost	-	final stock of finished products.

Extraordinary items are defined more narrowly. The two characteristics that classify an extraordinary item are: (a) its unusual character, (b) its exceptional manifestation. Extraordinary items should be presented separately, as they can not be controlled by the company, they will not recur in the foreseeable future and therefore will not be used for estimations. Profit and loss in the U.S. is designed to estimate future cash flows generated by the company.

3. THE BRITISH ACCOUNTING SYSTEM AND THE PROFIT AND LOSS ACCOUNT

In the British system, company law recommends four models for the presentation of profit and loss account, resulting from the combination of the two modes of analysis of expenditure, by function or by nature, with the two presentation modes - list or account sheet. In all four models (formats) the classification of expenses and revenues is obvious: expenses and income from ordinary activities and extraordinary expenses and income from extraordinary operations. However, in ordinary revenue and expenses structure, there are found both elements of the operating activity and financial elements. However, the purpose is not to determine a distinct result at the level of “operation”, nor “financial”, respectively. In all cases, tax on ordinary activity income is presented separately from tax on extraordinary operations income.

Format 1 (analysis of expenses by functions and list presentation) is aimed at determining the gross. Clearly, there are also determined the current result, extraordinary result and net result.

Format 2 (expenses analysis and list presentation) is oriented towards the pivot indicator “activity production”, although it is not represented as such; the structure according to the nature of expenses (and revenues) creates conditions for determining the "intermediate accounting balances"; the presence both of exceptional and of the extraordinary expenses, shows the need to clarify its nature and content.

In what concerns format 3 (analysis of expenses by function and horizontal presentation), the only information on company performance which appear in the account structure are: the result of ordinary activity after tax and the net result of the activity, in debit or credit, taking into consideration the loss or the profit.

Format 4 (analysis of expenses by nature and horizontal presentation) is oriented towards the pivot indicator "activity production", although it is not presented as such.

Also, the structure by nature of expenses (and revenues) creates conditions for determining the "intermediate accounting balances. The only information on company performances (levels of result) that appear in the account structure are: the result of ordinary activities after tax and net activity result, in debit or credit, for loss or profit, according to the situation. It appears as necessary the definition of the nature and content of exceptional expenses and extraordinary expenses, both present in the account structure. The British accounting the model with list presentation and analysis of expenses by function has the highest use.

4. PROFIT AND LOSS UNDER EUROPEAN DIRECTIVE

Fourth Directive of the European Economic Community, in order to insure a reliable image, mentions compulsory formats for establishing the balance sheet of the profit and loss account, and determining the minimum content of the appendix and the annual report. Member States may authorize one or more formats regarding the profit or loss account, from the four formats listed in the Directive. If a Member State takes into consideration more than one format, it can give entities the possibility of choice between these formats.

The first model of presentation of the profit and loss takes into consideration the classification of revenue and expenses accounts according their presentation patterns:

- in the form of account, expenses and loss presentation on the left and revenue and profits on the right;
- in the form of list, by deducting expenses from income to show how the result is formed.

The second format of presentation of the profit and loss account contains the classification of revenue and expenses accounts by content information:

- presentation of the profit and loss by the economic nature of transactions;
- presentation of the profit or loss by business functions: production function, sales office function and administrative function.

Differentiation in the classification pattern occurs only at the level of grouping the operating expenses.

Formats submitted by the Fourth Directive include the concept of extraordinary results, a concept abandoned by the international practice. Profit and loss account should allow financial markets to establish predictions on the future performance of the company. Introducing extraordinary items provides useful information in making such forecasts and their presentation separately in the profit and loss statement is perfectly justified.

5. PROFIT AND LOSS ACCOUNT FROM THE POINT OF VIEW OF THE ROMANIAN STANDARDIZATION BODY

In Romania, the profit or loss is covered both in terms of content and format by OMFP no. 1752/2005 as amended by OMFP no. 2734/2007.

The order allows the classification of expenses by nature, but requires the submission of an explanatory notes on the classification by purpose, in order to meet the requirements of IAS 1. Exceptional items of income and expenditure are waived and extraordinary income and expenses structures are adopted, although there are differences in content between the two types, without entering into the essence of this way of structuring. Romanian legislators have elected and imposed the list-format in which elements are classified by nature, by taking over the Fourth Directive and to meet the IAS1 provisions, they require a presentation note containing the Analysis of operating result. But there were given no explanations for this choice. A justification for the choice of one model or another has been found in the arguments of Professor M. Ristea. The author starts from the indicators on which are centered the two schemes (turnover and activity production for the classification by nature and turnover and cost of sold goods for the classification by destination) and **we observe that the model by nature** provides useful information to the **financial analysts** and **factors that participate in the creation and distribution of wealth** (investors, creditors, employees, etc.) – **the financial outlook of performance**, while **the model by destination is useful to the management**, by comparing costs of various functions to the sold production, generating information on the efficiency of the activity (of production, but also management) – **the economic outlook of performance**.

To meet the requirements of international standards (IAS 33 Earnings per share) the Romanian legislators have included in previous legislations as the last item in the format of the profit and loss account the **Result per share**. This item cannot be found in the format of the Directive, or in the model recommended in the Appendix to IAS 1, which gave the authenticity of the Romanian regulations. The new version of the regulations excludes this indicator in order to comply with the European Directive. Changes in inventories are shown in the operating income structure (with the plus sign in the case of storage or a minus sign in the case of unstorage). The cause of these differences is to be searched in the French profit and loss statement which served also as a model of profit and loss account made by the Romanian companies, as an effect of the putting into practice of the accounting regulations harmonized with Directive IV of the European Union and the international accounting rules, a challenge for accounting professionals. They must give up some of the reflexes formed in terms of assessing the nature of expenses and income but also in what concerns the construction of the profit and loss account. Although the Romanian accounting standards are synchronized with the Fourth European Directive, surprisingly, they did not let the opportunity to choose between several **models of presentation of the profit and loss**, as in Poland and Hungary.

Why is there no possibility of existence of other model formats of profit and loss, as long as we are interested in attracting new investors and in capital market development in Romania, also taking into account the companies' requirements? The format **by nature** is predominantly orientated towards the **fiscal** aspects, while the format **by destination** is predominantly oriented towards **investments**. Classification of expenses by nature is meat in those countries which promote a legal concept of accounting. As it is the case in France, Germany, Italy, Spain and Romania. According to the International Accounting Standards, companies should analyze, in the profit and loss statement or in notes, the expenses grouped either by nature or by function, respecting the minimum number of elements in the standard. We mention that these references to a series of regulations will soon be outdated, not so much because at the moment of the documentation they are still in exercise, but in order to emphasize the evolution of the standardization of financial statements in Romania.

6. CONCLUSIONS

Comparative analysis of presentation patterns of the profit or loss highlights an Anglo-Saxon cult, pointing towards a presentation of operating expenses by company functions, unlike the European cult of organizing operating expenses by nature. IASB has attempted to achieve reconciliation between the two cultures by providing the option of presenting the operating expenses by nature or by company functions.

European directives, trying to harmonize with the international standards, offer the option of submitting the operating expenses by one of two criteria.

In the practice from our country, this option does not exist, because of the accounting rules that persist, and the professional reasoning is restricted by these regulations. A profit and loss account is created which classifies operating expenses by nature. Regarding the creation of the profit and loss account with a classification of expenses by company functions, no one forbids such a practice, and it seems that listed companies will not avoid doing so. Between the profit and loss account in our country and the one under the Fourth Directive, there is only a small difference in the presentation of income taxes. Income taxes in the account in our country are presented cumulatively, whereas under the European referential they are presented separately for the regular activity and the extraordinary one. The international referential and British one prohibit separate presentation of extraordinary items, but the American referential and the profit and loss account in our country present extraordinary items separately.

For reporting financial performance it is required the preparation of two financial statements: profit and loss statement and the statement of changes in equity; if the statement of changes in equity will continue to be demanded, there is the possibility of shifting the profit and loss statement in second place.

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