Subjectivity in the interpretations of financial performance

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Subjetividad en las interpretaciones del desempeño financiero

ABSTRACT

The article provides an analysis of dynamic profit (income from operations) and examines the methods of its generation. The distribution of expenses by periods and corporate accounting policies have been identified as subjective factors affecting this indicator. The static interpretation of the financial performance of an organization (return on investment) has been analyzed. The concepts of capital maintenance recommended by IFRS have been reviewed in the context of their application in Russia, taking into account the effect of inflation. It has been concluded that in Russia neither static nor dynamic profit is formed in its pure form. The study is based on the analysis of fundamental accounting assumptions (the theories of static and dynamic balance-sheet), research papers on accounting, and the legislation of the Russian Federation governing the business activities of legal entities. The study has justified the use of both dynamic and static profits in the creation of financial statements and proposed a way to represent these data in a single reporting format.

KEYWORDS: Financial performance, profit, dividends, dynamic profit, static profit, capital, inflation, elements of accounting policies, organization.

RESUMEN

El artículo proporciona un análisis del beneficio dinámico (ingresos de operaciones) y examina los métodos de su generación. La distribución de gastos por períodos y políticas contables corporativas ha sido identificada como factores subjetivos que afectan este indicador. Se ha analizado la interpretación estática del rendimiento financiero de una organización (rendimiento de la inversión). Los conceptos de mantenimiento de capital recomendados por las NIIF se han revisado en el contexto de su aplicación en Rusia, teniendo en cuenta el efecto de la inflación. Se ha concluido que en Rusia ni la ganancia estática ni la dinámica se forman en su forma pura. El estudio se basa en el análisis de supuestos contables fundamentales (las teorías del balance estático y dinámico), los documentos de investigación sobre contabilidad y la legislación de la Federación de Rusia que rige las actividades comerciales de las entidades jurídicas. El estudio ha justificado el uso de beneficios tanto dinámicos como estáticos en la creación de estados financieros y propuso una forma de representar estos datos en un solo formato de informe.

PALABRAS CLAVE: desempeño financiero, ganancias, dividendos, ganancias dinámicas, ganancias estáticas, capital, inflación, elementos de políticas contables, organización.

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INTRODUCTION

Profit is a specified rate that depends not only on business results. Profit cannot be measured, it can only be calculated. Hence, the question arises of how to calculate the financial performance of a company? The main interpretations of profit are based on the assumptions of static and dynamic balance-sheet. In the economic literature, dynamic profit is often called accounting profit, and static profit is often referred to as economic one. The former determines the profit as the result of the sale of goods or services, and the latter as the result of the "work" of capital ".

For many years Russian accountants mainly used the so-called dynamic profit, since no revaluation of property was carried out. But the market economy and the development of private property have changed the requirements of users for the accounting (financial) statements. Currently, the main users of accounting (financial) statements are the company owners (shareholders). One source of owner's income is dividend, the source of which is profit. Therefore, the owners need the objective information about the financial performance of a company to make investment and financial decisions. Information recorded in the accounting system should be relevant to the needs of its users (Tkachuk, 2016, 2018; Safdari & Asadi, 2013).

LITERATURE REVIEW

Many well-known scientists pay attention to the subjectivity in measuring the financial performance (Ya.V. Sokolov, V.V. Kovalev, Vit.V. Kovalev, N.N. Karzayeva, A.D. Larionov, A.I. Nechitaylo, Hendriksen, Van Breda, etc.). According to Hendriksen and Van Breda, accounting profit "does not reflect the real-world phenomena, since the accountants create their principles and rules based on ideas that may come from outside the reality" (Hendriksen, van Breda, 2000). Ya. V. Sokolov wrote: "... who needs the concept of profit: an accountant or his employer, what is the structure of profit and how it is calculated are questions of the highest importance" (Sokolov, 2000). Underlining the subjectivity of the financial result, V.V. Kovalev and Vit.V. Kovalev defined profit as "a conditional indicator, meaning a certain income from operations, requiring some investment and (or) expense and manifested in an increase in the total economic potential of an investor at the end (actual or conditional) of this operation" (Kovalev, Kovalev, 2012).

The subjectivity of this indicator sometimes gives rise to anomalous situations. The entrepreneur believes that his company gets profit, but accounting statements show losses or vice versa. This situation was commented on by A.D. Larionov and A.I. Nechitailo: "The reason for this contradiction is specific accounting techniques: depreciation and capitalization of expenses" (Larionov, Nechitaylo, 2004).

The problem of using different indicators from both static and dynamic balance-sheet in a single statement has been raised in the works of M.L. Pyatov (Pyatov, 2010). The role of scientific paradigms in accounting, allowing the selection and building of indicators relevant to user needs, is discussed in the article by E.I. Zugi (Zuga, 2010).

METHODS

Fundamental assumptions of accounting theory: the static and dynamic balance-sheet, - have provided the methodological framework to the current study. The study is based on the analysis of research papers in the field of accounting and regulatory documents governing the process of creation and functioning of legal entities in the Russian Federation

DISCUSSION AND RESULTS

One of the objectives of dividend policies, as part of the company's financial policies, is to find the optimal ratio between dividend distribution and reinvested profit in order to preserve the financial stability , that is, the ability to maintain uninterrupted operations and to provide incomes for owners.

A dividend is essentially the income from investments paid to the shareholders of a company. The company's dividend policies do not consist only in balancing between the owners' income and profits invested in the company's development, but also promote its positive image, which implies the stability of prices of company's shares, their attractiveness for investors. At the same time, it is necessary to keep a balance between the funds allocated for payment of dividends and necessary investments in business development. The dividend strategy should be transparent and clear for investors. For the owners of large stock packages, dividends are not very significant, the ability to take control over the enterprise is a matter of much interest for them. But the income from their ownership is very important for minority shareholders,.

Corporate profit is the source of dividends paid to shareholders. The economic meaning of "profit" indicator is to characterize the effectiveness of business activities. Therefore, the measurement of company's financial performance can be considered as one of the most important problems of accounting.

However, profit is a subjective indicator. Interpretations of financial performance are different in dynamic and static balance-sheet theories. At present, it is the dynamic approach that prevails in national regulatory system.

DYNAMIC PROFIT:

Based on the main provisions of the dynamic balance-sheet theory, the financial result is the difference between the income and expenses of a company:

$$P/L = Ip - Ep$$

where:

P/L – profit/losses in the reporting period;

Ip – income in the period.

Ep – expenditure in the period.

Unlike other elements of financial statement: assets, liabilities and equity - definitions of income and expenditure of an organization are present in the current regulatory documents. The definition of income and expenses is presented in Russian Federal Standards PBU 9/1999 "Incomes of the organization" and PBU 10/1999 "Expenses of the organization". In accordance with these documents, "the income of an organization is an increase in economic benefits resulting from addition of assets (cash, other property) and (or) settlement of liabilities, leading to an increase in corporate capital, except for contributions of participants (property owners)". "A decrease in economic benefits during the reporting period in the form of withdrawal of assets or in the form of occurrence of liabilities that lead to a reduction of own capital (at that, such reduction is not related to payments to founders) is recognized as expenses".

Currently, there are two main approaches to the definition of income and expenses: the accrual method and the cash method. The accrual method is currently enshrined in the domestic regulatory documents as the main one. The accrual method does not take into account the cash flows, which are of major importance for cash method. Only some organizations have the right to recognize incomes and expenses upon payment in accordance with clause 12 of PBU 9/1999 "Incomes of an organization" and clause 18 of PBU 10/1999 "Expenses of an organization".

The following factors affecting the calculation of profit from ongoing operations may be identified:

1. The timing of expenses and revenues and matching of costs with revenues , since profit is the difference between recognized and interrelated revenues and expenses in the reporting period;

2. Elements of accounting policies involved in generation of accounting information about the expenses:

- methods of calculating the depreciation of fixed assets (linear, nonlinear (reducing balance) methods, the direct sum-of-the-years'digits method and the units of production (output-based) method;

– stock outs record (based on average cost, first-time purchases or each item cost);

– indirect costs recovery etc.

Thus, the financial result of ongoing operations depends on many factors. T.M. Odintsova draws attention to the fact that the profit can vary easily and depends on the moment of recognition and type of income and expenses (Odintsova, 2013). V.Ya. Sokolov describes in particular the process of capitalization of non-current assets (Sokolov, 2011).

Obviously, the information on dynamic profit is very important for assessing the ongoing operations. The calculation of dynamic profit as the difference between current income and expenses, in its classical version, should be based on the historical value of assets.

However, the recognition of current incomes and expenses on an accrual basis is ambiguous. Many entrepreneurs associate the profit indicator with cash. In accounting there are some paradoxes, analyzed in detail in the works of Ya.V. Sokolov. One of these paradoxes is: "there is profit, but there is no money." Eminent experts believe that recognizing a financial result based on the accrual method is too optimistic. In particular, I.I. Eliseeva concluded that reforms of accounting should follow the principle of conservatism: the revenue should not be recognized at the moment of ownership transfer, but when the cash is received, otherwise there will always be a risk of the build-up of asset bubbles, and such anomalous situations as a highly profitable enterprise going bankrupt will occur". (Yeliseyeva, 2010).

STATIC PROFIT:

The approach based on dynamic balance-sheet is more narrow than the static balance-sheet approach. Static profit is an increase in the owners' capital resulting from business operations, i.e. return on investment. To calculate the static profit, the data on the market value of assets and liabilities are indispensable, and this introduces even more subjectivity into this process, as discussions about the accuracy of determining the market value as the fair value of items are still ongoing. Reliability of fair value measurement is discussed in the relatively recent works of G.Whittington (Whittington, 2015) and S Fearnley., S.Sunder (Fearnley, Sunder, 2007). J-M Hitz considers fair value as a specific hypothetical price under ideal conditions (J-M Hitz, 2007). The choice of an appropriate basis for financial statements is a fundamental and controversial issue noted by Ryan P. McDonough and Catherine M. Shakespeare (McDonough, Shakespeare, 2015). According to S. Nobes, different approaches should be used for different types of assets to determine their fair value (Nobes, 2001). The problems of using the fair value of non-financial assets are reflected in the article by R Barker, S Schulte (Barker, Schulte., 2015). Anderson S B., Brown J L., Hodder L, Hopkins P. E. (Anderson, Brown, Hodder, Hopkins, 2015) draw attention to the feasibility of using fair value for a company's valuation.

Opponents of accounting at fair value believe that the financial statements based on the fair value measurement became one of the causes of the 2007–2009 financial crisis (Procházka, 2011). Chairman of the IASB, Hans Hoogervorst (Hoogervorst, 2015), in one of his speeches, called the issue of valuing assets and liabilities one of the most controversial in accounting. Although such scientists as N.N. Karzayeva emphasize the basically subjective nature of valuation (Karzaeva, 2005).

In the classic version, the static profit is recognized if the amount of equity at the end of the period is greater than at the beginning of this period, provided that the contributions and withdrawals of owners are ignored:

$$RLI = E1 - E0 - OC + OW$$

where:

RLI – return/losses on investment for the reporting period;

E1 – equity at the end of reporting period (assets minus liabilities at market value);

E0 – equity at the beginning of reporting period (assets minus liabilities at market value);

OC – owners' contributions in the reporting period;

OW – owners' withdrawals in the reporting period.

The static interpretation connects the "profit" concept with the concept of "capital": the capital generates an income, which is its increment. The eminent economists A.Smith, I.Fisher, J.Hicks have the same view. The shareholders commonly consider the profit as the result of their investments "work". In this connection, one of the frequently cited definitions of income by J. Hicks (1904-1989) should be mentioned: "Income is the maximum amount which can be spent during a period if there is to be an expectation of maintaining intact, the capital value of prospective receipts" (Hicks, 1946). This statement can be adapted to the conditions of a company: its net profit represents the maximum amount that the owners of the organization could withdraw in the form of dividends during the reporting period and have the same equity as at the beginning of the reporting period. In general, information about profits is based on the fact that shareholders consider an enterprise as an object of investment, and the indicator "profit" is the result of the work of these investments. Ya. V. Sokolov argued that "in terms of double-entry bookkeeping, revaluation of assets is a profit. Consequently, the increase in assets on the balance, not related to the growth in the liabilities, looks like an increase in profit, but it is obvious that this is not a real profit: first, the asset has not yet been sold; secondly, as F.V. Yezersky wrote, this is only a dream of profit; thirdly, it is the door for a multitude of possible abuses - raise the value and get what you want "(Sokolov, 2010).

Understanding of profit as the "work" of investment is reflected in the concept of preserving (maintaining) capital, declared in IFRS. Therefore, when comparing equity at the beginning and at the end of a period, it is necessary to take into account not only owners' transactions, but also the time factor. It can be said that the purpose of applying the concept of maintenance of capital is to objectively assess the financial performance of a company.

IFRS offers two ways to apply this concept: maintenance of financial capital and maintenance of physical capital. The former defines financial capital as a company's net assets. Profit is the difference between the value of net assets at the end of the year and the amount of net assets at the beginning of the year (contributions and distributions of owners during this period are ignored). Physical capital is considered as the productive capacity of a company, determined by the volume of its output. Unfortunately, there is no clear methodology (or recommendations) for calculating the physical capital in the economic literature, and in IFRS itself. Profit is the excess of operating capacity of a company at the end of the reporting period over the same value at the beginning of the reporting period (excluding owners contributions and distributions). Only an increase in assets exceeding the amount needed to preserve physical capital can be considered as profit or as a return on investment.

The concept of capital maintenance, according to IFRS, "is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital.

Thus, using the concept of capital maintenance, the static profit formula is complemented by an adjustment to maintain capital, i.e., profit is earned if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period , after excluding any distributions to, and contributions from owners during the period:

$$RLI = E1 - E0 - OC + OW - Am$$

where:

Am is adjustment for maintenance of capital, according to the methodology adopted by the enterprise.

From the point of view of shareholders and stakeholders, profit is the return on their investments and the increase of their capital. Such information is provided by static profit which is used for dividend payments.

Since the owners are first interested in the purchasing power of the invested capital, it becomes necessary to use foreign experience in assessing the financial performance of economic activities of an enterprise, applying the concept of financial capital maintenance proposed by IFRS. It may seem that this question is not so important. However, the high inflationary tendencies characterizing Russian economy make it necessary to apply the concept of capital maintenance.

The adjustment for the maintenance of capital allows taking into account the time value of money when assessing the financial performance of enterprises and the comparability of data for different time periods (Example 1).

Example 1.

Basic data:

1. E1 – 12 000 000 rubles;

2. E0 – 8700 000 rubles;

3. OW – 300 000 rubles. (dividends);

4. Inflation rate in the current year – 7%

Am for the reporting period: 8700 000 rubles. x 7% = 609 000 rubles.

RLI = 12 000 000 – 8700 000 + 300 000 – 609 000 = 2991 000 rubles.

V.V. Marin and V.D. Novodvorsky believe that the capital maintenance mechanisms do exist in Russian regulatory documents and are partially implemented in the Civil Code of the Russian Federation, and the Federal Laws "On Joint Stock Companies" and "On Limited Liability Companies" (Novodvorskiy, Marin, 2004). In this case, we cannot fully share the experts' opinion, we believe that the limitations presented are not related to the information about the profit, but indicate a certain relationship between the size of the company's authorized capital and the value of its net assets. The legislative acts require only that the value of company's net assets be greater than the value of its authorized capital.

Only market valuations of assets should be used when calculating the static profit. The static profit is often called business profit, since it is this interpretation of the financial performance that is familiar and more understandable for company's owners. Hence, if the static profit is the increment of owners' capital over a period, then the dynamic profit shows only its part resulting from current operations. It can be said that the return on invested capital (static profit) includes the profit from current operations (dynamic profit) and the profit from changes in accounting estimates (Example 2).

Example 2.

Basic data:

1. E1 – 19 000 000 rubles;

2. E0 – 13 700 000 rubles;

3. OC – 400 000 rubles;

4. OW – 800 000 rubles (dividends);

5. Inflation rate in the current year – 6%;

6. Ip – 4000 000 rubles;

7. Ep – 2200 000 rubles

Am for the reporting period: 13 700 000 rubles x 6% = 822 000 rubles.

RLI = 19 000 000 – 13 700 000 – 400 000 + 800 000 – 822 000 = 4878 000 rubles.

P/L = 4000 000 – 2200 000 = 1800 000 rubles.

Therefore, the profit from the changes in accounting estimates: 4878 000 – 1800 000 = 3078 000 rubles.

The subjectivity of "profit" is reflected in the existence of two fundamentally different approaches (static and dynamic), and various methods of their application (using the concept of capital maintenance and different ways of recognizing income and expenses). The obvious subjectivity of this indicator suggests that external users of information about the company need to be provided with two basic interpretations of the financial performance, with justification of the most useful methods of application.

Mixed approaches:

The existing accounting system provides for a mixture of estimates, which means that an organization can use both market value and historical cost. In some situations, it is the right of an enterprise to replace the historical cost with the market value, and in some cases, it is its duty.

But the result of the revaluation of fixed and intangible assets (if it is carried out) is not included into financial result of the organization. In Russian accounting system, the revaluation of assets forms the "Additional capital". But the devaluation of fixed assets and the devaluation of current assets are included in the financial result of the company.

The concept of "cumulative financial result for the period", as a kind of static profit, was introduced into the national accounting system in 2011. This indicator is the result of changes in equity for the period, excluding owners' contributions and withdrawals. Its essential feature is that it is formed not in the accounting system, but only in the statement of financial performance: net profit (loss) plus the result from revaluation of non-current assets (amounts not included in the net profit (loss) of the period) plus the result from other transactions (amounts not included in the net profit (loss) of the period). Therefore, the cumulative financial result is not considered as distributable profit in the Russian accounting system.

Russian accounting practice does not allow obtaining information on the return on invested capital (static interpretation), nor information on profit from ongoing operations (dynamic interpretation). This circumstance further contributes to subjectivity in the recognition of the financial performance of the organization. The availability of comprehensive information on the financial performance will have a very positive impact on the sustainable development of enterprises, the management of which is largely discussed in the works of modern researchers (Rokotyanskaya, 2017).

CONCLUSIONS

The results of our study allowed to draw up the following conclusions:

1. Profit is a calculated, and, therefore, a subjective indicator. Not only different interpretations of profit are identified, but also different methods for calculating it within each interpretation. In this article, we examined only two interpretations based on the theories of static and dynamic balance-sheet. To evaluate the financial results of the organization, the users of accounting statements need to be provided with several interpretations of financial performance of an enterprise. Of course, it is inappropriate to offer the user all the existing diversity of evaluations of financial performance. Besides, it is difficult to combine these evaluations in one single statement.

2. Two main indicators of financial result: static and dynamic profits, can help users of accounting information to assess the effectiveness of company's activities. The static profit shows the result of operations with capital, and the dynamic one reflects the result of ongoing operations. Specific methods for calculating static and dynamic profits should be established by company itself;

The current system for generating accounting information, both in Russia and in IFRS, based on a mix of estimates, makes the process of evaluating the financial performance of an organization even more subjective and undescriptive.

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