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Cognitive Valences and Limits of the Accounting Information Provided by the Balance Sheet and the Income Statement

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Abstract: *The balance sheet and income statement are considered the most important documents of financial reporting, at least in terms of professional accountants.*
This article aims to emphasize different approaches regarding the balance sheet and the income statement, as well as valences and limits of these components of financial statements.
Keywords: *balance sheet, income statement, accounting and financial information*

Introduction

Priority disputes on the information utility market, between the balance sheet and the profit and loss account, have been nourished, in different periods, by the contradictory evolutions between the credit-based financing and the share-based financing which have generated oscillating variations of economic results, and from here the practical interest oriented towards one or the other synthesis document.

1. The Balance Sheet

It is generally said that the balance sheet is the main and characteristic instrument, by means of which the synthesis and generalisation of accounting data are realised.

Over time, the specialists have formulated different definitions of the balance sheet, which are different by certain expression nuances [17, 45; 15, 5-20; 14, 195-206]:

The balance sheet is a document for informing the shareholders and third parties on the economic and financial situation of the company where they have funds. The balance sheet is thus one of the most elastic documents, which mirrors only what the manager wants.

The balance sheet is the form used in the practice of economic life, for the written presentation of wealth, obligations, equity, such as the use of fortune and its replacement by rules which have been proved to be especially useful to the efficient economic management (W. le Coutre).

The balance sheet is a faithful mirror of the past and at the same time a safe guide of future operations, ... an overview of the inventory, i.e. of the assets and liabilities of an enterprise, and the operation whereby a merchant puts face to face its assets and liabilities, accurately tracking the result obtained in the course of a year. (Th. Ştefănescu).

Balance is an instrument of knowledge of how the structure of wealth and capital evolves year after year, as well as the obtained results, while for the outside world, the balance sheet is the only means of information on the economic and financial situation of the enterprise at the date when the balance was closed (I. Evian).

The balance sheet is the main and characteristic tool of synthesis and generalization at a given time, on the basis of the principle of double representation of accounting data on the economic means and their sources of information, as well as the results of the activity to all links of the national economy (C.G. Demetrescu).

The balance sheet is a synthesis calculation indicating the actual status of the company's activity allowing the perception from only one sight of the economic legal and financial situation of the company, showing in detail the character of its means of action, its own and external resources, including the final result (D. Rusu).

From the expressed views, we believe that there are certain common elements that are explicit or implicit, according to which the balance sheet [17, 46]:

- is a document of accounting synthesis and practical tool for managing assets;
- mirrors the company's wealth and its evolution as well as its financing sources;
- determines the result (profit or loss) for the fiscal year;
- is a tool for opening and closing of the fiscal year;
- it is a source of information for the financial and patrimonial analysis, expressing the main balance functions such as: the function of reflection and generalization, analysis and control, instrument of economic-financial equilibrium, patrimony disconnect and foresight.

The balance sheet reflects the *financial position* represented by the company's capacity to adapt to environmental changes by means of controlled economic resources (assets), the structure of financing (equity and debt) and by means of economic and financial indicators of liquidity and charge.

In other words, the balance should cover all categories of assets (resources used) owned by the business at some point (the date it is drawn up), as well as all debts to shareholders and creditors (sources of funding).

The balance sheet is also called *the financial position of the business* or *the situation of the company's financial situation*, its main property being the permanent and binding equilibrium between assets and liabilities (elements of equity and debt) [12, 19].

Even though most users consider the balance sheet as an essential document for the financial analysis, there are a number of limitations: [1, 63]

- the absence of balance sheet positions reflecting internal resources created by the company and which cannot be attached to any costs, such as the collective experience of the team of employees;
- the evaluation based on historical costs calls into question the veracity of the financial situation at the end of the year;
- the effect of recognition principle in the annual accounts, only of those costs that contributed to obtaining revenue during the period in question;
- the variations in the monetary mass (especially in inflationary periods) decrease the confidence in the relevance of accounting synthesis documents and lead to the consideration of other sources of financial information for investment decisions;
- business fluctuations between the moments of the ending of the year and the beginning of the next accounting cycle are not included in the balance sheets;
- the influence of external non-monetary factors on the company's activity cannot be reflected by means of the annual accounts.

Despite these limitations, we believe that the dynamic analysis of several successive balance sheets may constitute a basis for the design of provisional balance sheets, conditioning thus the financial decision and the future behaviour of the company.

Consequently, the accounting balance sheet will be changed in a financial balance sheet (liquidity-charge) and also functional in order to obtain a true and fair view.

The purpose of the financial balance sheet is to inventory the company's wealth and commitments and order them on liquidity term, based on the information presented in the accounting balance sheet and in the notes. The utility of the financial balance sheet can be seen from two points of view [2, 56]:

a) from the point of view of financial analysis users:

- *shareholders* who wish to know the value of their assets, the evolution of its size and its liquidation duration in the event of a recovery of capital;
- *creditors* who wish to know the value of the company's assets which is the guarantee of their rights;

b) From the point of view of how they meet the requirements and objectives of the financial analysis, the grouping of patrimonial elements within the financial balance sheet allows:
   - the analysis of financial patrimony structure;
   - the analysis of financial equilibrium;
   - the analysis of the company's creditworthiness;
   - the analysis of risks;
   - the setting of the company's patrimonial value.

Although subject to criticism (the sometimes arbitrary classification of elements concerning liquidity and exigibility, the assessment from a liquidity point of view of accounting values, static nature of data taken from the patrimony balance sheet, the absence of normative references of the working capital),the balance sheet provides the company's management interesting information for improving treasury by the rational dimensioning of the working capital and accelerating the speed of rotation of circulating assets.

The analysis of the functional balance sheet provides financial information on the measuring of financial equilibrium between the company's needs and their financing resources by means of functions (cycles) that characterise the company's activities: the operating, investment and financing functions.

Treasury is considered to be the resultant of these functions. It can increase from the cashing of operating activities, from the sale of fixed assets, attracting capital and can decrease by payments for the financing of operating activities, investments and debt repayment. Positive balance of Treasury means greater receipts than payments, and the negative balance of payments signifies the recourse to short-term loans [7, 72].

The construction and analysis of the functional balance sheet more on empirical criteria than on the theoretical principles and rules (determination of the cash balance on each function, contrary to the principle of cash unity; the privilege of stable funding which is more expensive to meet working capital need, the conception to subordinate the Treasury of balance at the top of the sheet), do not underestimate the role of this type of balance suggesting, in exclusivity, company's management the need to understand the correlation between financing needs with funding sources on each functional cycle in the development of the working activity.

The company's management requires the balance sheet to meet several whole purposes, of information and control of the economic activity, a comparative analysis and the substantiation of decisions regarding the next period. The theory has demonstrated, and the practice has confirmed the balance sheet as a basic information and decision-taking tool of management.

Regardless of the approach, the balance sheet must create the true view of the company. So, Bernard Colasse considers that the balance sheet does not render the image of a company as a mirror reflects our image, but also creates an image of the company [6, 124].

2. The Income Statement

If the balance sheet highlights the patrimony status on the date of the financial year, the account of the results, using the financial flow of income and expenditure, it also outlines the way it came to the final patrimony state.

The profit and loss account is the financial statement which measures the company's financial success or performance and provides information useful to investors (concerning the company's economic value), to creditors (on the indebtedness capacity and repayment of debts).

The profit and loss account, as a document explaining variation in patrimony, has been shaped in the second half of the 14^{th} century and conditioned to a significant extent by the evolution of the balance sheet.

The consecration of the balance sheet and profit and loss account was done in 19^{th} century and the first half of the 20^{th} century.

In the early twentieth century, Eugen Schmalenbach opposes traditional patrimony vision of the balance sheet a dynamic analysis that focuses on the measurement of result, considered more useful for managing the company [8, 67].

W.A Paton and A.C. Littleton Develops in the years '30 a model for the determination of the result based on the "conventional accounting theory". According to this theory, the profit and loss account is a summary of the managers' use of the resources entrusted to them in the course of a period of time. In the opinion of the two American theoreticians, the main function of accounting is to calculate a residual value, a balance, as the difference between revenue (effects) and costs (effort). The difference reflects the management efficiency and proves significant for bringers of capital who assume a risk [8, 68].

The result is defined by Bernand Colasse, from the patrimony point of view, as variation of the company's patrimony, during a financial year, variation representing a consequence of its activity: as such, the result is only a part of equity, at the end of the year, and the profit and loss account, an account of equity.

In Romania, the concern of specialists for the profit and loss account has occurred only in the period 1844 - 1845, by Dimitrie Iarcu. It seems that he is the first author who presents the account *Gain and damage*. Though it does not claim the quality of financial statement, but only a party (an account) within *The Master*, whose balance was taken by the party "Capital", it highlights the result of the company's balance over a period of management by means of total gain (income) and damage (expenditure) [3, 50].

The analysis of the profit and loss account is interested in knowing the final result obtained by a company, but most important is to consider the stages occurring in its formation, so as to know the economic behaviour of the company. To do this, there are determined *the intermediate management balances*, which helps to complete the information contained in the profit and loss account, although it does not replace the determination of the obtained result [4, 451].

The table of intermediary management balances

Table 1.

INCOME ITEMS	***EXPENDITURE ITEMS***	***INTERMEDIATE MANAGEMENT BALANCES***
line 1	line 2	line 3 = line 1 – line 2
Value of sold goods	Purchase cost of goods	*Commercial margin*
Sold production Stored production Production made by the entity for its own purposes and capitalised	Non-stock production	*Production of financial year*
Production of financial year Commercial margin	Total material expenses Works and services done by third parties	*Added value*
Added value Operating subsidies	Total staff expenses Duties, taxes and similar levies	*Gross operating surplus*
Gross operating surplus Other operating income	Value adjustments of fixed assets, circulating assets and adjustments concerning provisions Other operating expenses	*Operating result*
Operating result Financial income	Financial expenses	*Current result*

Extraordinary income	Extraordinary expenses	*Extraordinary result*
Current result Extraordinary result		*Gross result of the financial year*
Gross result of the financial year	Profit tax	*Net result of the financial year*

The table of intermediary management balances corresponds to a presentation of the profit and loss account in the form of a sequence of margins consisting of steps which lead to the formation of corresponds to a presentation of the profit and loss account in the form of a sequence of margins consisting of steps which lead to the formation of the net result [10, 30].

The structure of the intermediary management balances' table is based on two principles [5, 305]:

- the analysis of expenditure and income on types of activities; there are therefore operating expenditure and income, financial expenditure and income and extraordinary expenditure and income;
- the emphasis of the result of current activities. The difference between current and extraordinary activities is given by the non-repetitive nature of the latter.

Each intermediary balance reflects the result of financial management at the respective accumulation step and has the following meanings:

The commercial margin is calculated as the difference between sales of goods and the cost of purchase.

Added value expresses an increase in the value resulting from the use of production factors, in particular its productive potential (labour and capital). Value added is the source of monetary accumulations from which there can be done the remuneration of direct and indirect participants to the economic activity: the state, employees, creditors, shareholders, the company (via self-financing capacity).

Gross operating surplus expresses the gross accumulation from the operating activity, acknowledging that depreciation, provisions and the adjustments for depreciation or loss of value are only calculated, not paid expenses. Therefore, up to their request (for investment, risks or costs) they are to be found in the company's liquidity. The gross operating surplus expresses the potential capacity for self-financing (from amortisation, provisions, adjustments for depreciation or loss of value, profit).

The operating profit expresses the absolute measure of the operating activity profitability by the deduction of expenditure (payable and calculated) of income (cashable and calculated).

The net profit expresses the absolute value of financial profitability with which shareholders are remunerated for subscribed equity, or there is a reinvestment in the company.

We can consider as limits of this type of analysis the following:

- the integration of the management accounting information is very reduced;
- the assessment of consumption is based on legal vision;
- seemingly beneficial, the information must be treated so as to formulate financial terms and indicators.

The profit and loss account provides for the company's management a basis of consistent information that allow, on the one hand, the knowledge of performances on a global level, and, on the other hand, the detailing of the revenue and expenditure items which have contributed to the obtaining of the result and to the identification and quantification of factors that influenced it.

However, managers can handle the company's accounting result, operation called *strategic management of the result,* by means of *calculated income and expenditure* (which do not generate treasury flows, as provisions and redemptions) and of *deferred expenditure and income* (which are not attributable to the profit and loss account; as the expenditure/revenue established in advance, which are "suspended" in the balance sheet and transferred to the profit and loss account as they become attributable to the financial year result in accordance with the principle of connecting expenditure to incomes), also called *regulating accounts of the financial year's result*, observing the accounting rules. In general, it is considered that the freedom granted to managers in assessing and presenting financial statements is given by the level of these calculated expenditure and income and, respectively, deferred, called *accounting variables of regularization* [13, 162].

The elastic nature of the result limits the information value of the profit and loss account which, sometimes, may become deceiving. For example, if we consider the statement: "the profit and loss account provides information on financial flows recorded at the end of financial year, in the form of profit or loss", it might be inferred that, by means of the profit and loss account there are created treasury flows. The answer is positive, under the conditions of cash accounting, and negative, if the accrual basis of accounting is practiced [16, 142-143]. Or, if two similar companies adopt different methods of depreciation, when the other factors are equal, they will register different values if the result.

Therefore, as professors Liliana Feleagă and Niculae Feleagă state, it is necessary to make a thorough analysis taking into account the quality of the benefits obtained by the company. If it has a tendency to use liberal accounting practice, it will make a higher profit in the short term, but the quality of such benefit will be low. The same thing may be said about a company that would get greater benefits in the short term, as a result of unusual events, facts that would not reproduce for a longer period [9, 85].

The balance sheet and the profit and loss account, as elements of financial statements, represent the heart of simulation models of the financial position, performances and the risks identified at the company level, models that are based on the following structure: [11, 113].

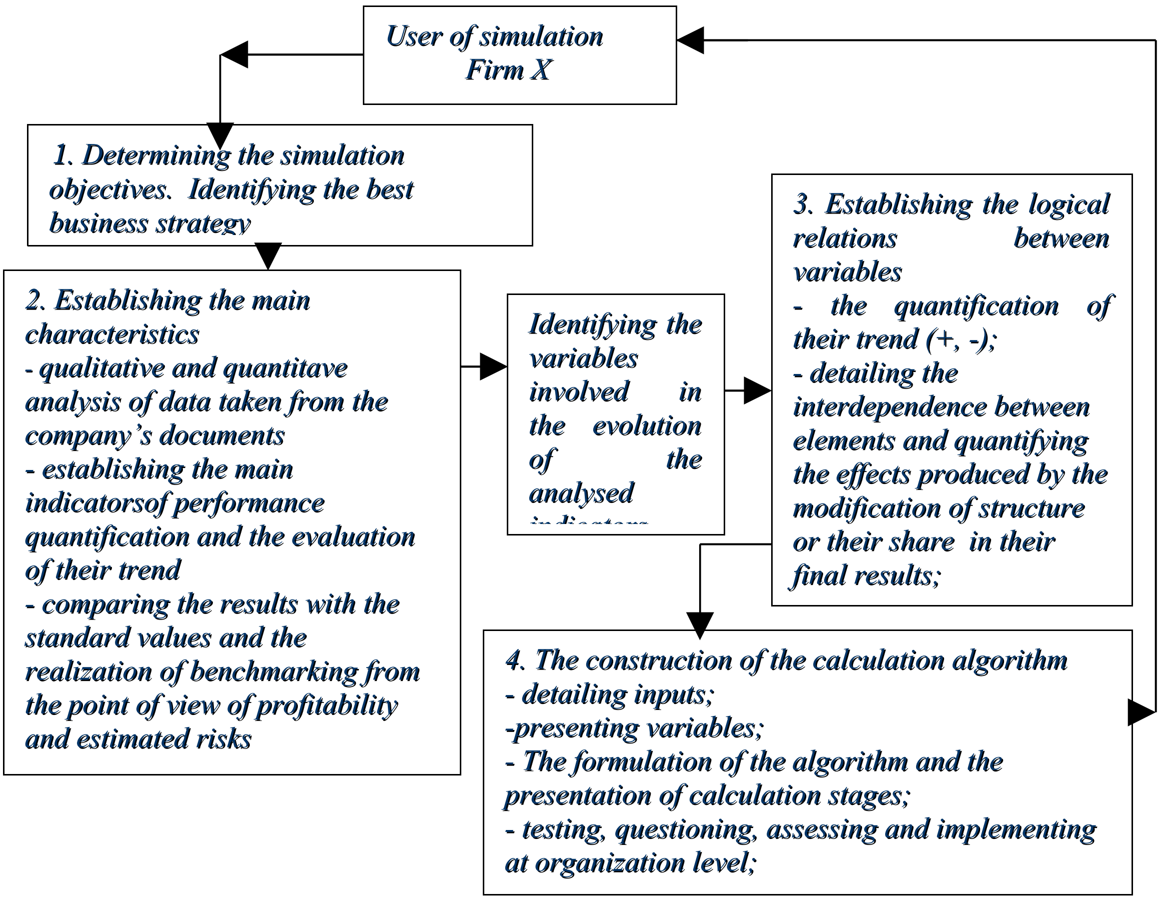

Figure 1. Stages in the elaboration of the simulation model

Conclusions

In the context of multinational companies' expansion, the users of financial information are more interested in the company's performance, determined on the basis of the economic result and less on the basis of the accounting result. This indicator cannot be highlighted directly by the profit and loss account, as the structure includes items that are not to be found in the profit and loss account.

The users of financial information are also interested in other information that the balance sheet and the profit and loss account cannot provide. In these conditions, the decision makers should call to new sources of information produced by accounting, as treasury flows and the equity change.

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