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PROFIT AND LOSS ACCOUNT OR COMPREHENSIVE INCOME STATEMENT: WHICH IS THE BEST?

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The net income was considered for a long period of time the main indicator for measuring the financial performance of the economic entity. It is said that when entity obtains profit then the entity does performance. The net income is oriented towards the past, by its method of calculation, serving as a measure of the progress of the entity during a period of time in the past. Currently, the net income lost and still tends to lose "land" in the process of measuring financial performance due to the emergence of a new concept: the comprehensive income. This study aims to identify which one of the two financial statements, which one discloses the performance of the economic entity: the profit and loss account or the comprehensive income statement preferred by investors. Based on data collected from the financial statements of the 62 companies listed on the London Stock Exchange, this study shows that profit and loss account is the financial statement preferred by investors in assessing the financial performance of the economic entity.

Keywords: Comprehensive income, IFRS, Net income, Performance

1. Introduction

For a long time, the accounting result was considered to be the main indicator for measuring the performance of the economic entity. It is said that when the entity obtains profit, it does performance. In the approach regarding the concept of profit, we will focus on some opinions expressed by authors that are known internationally. Adam Smith, quoted by Babeau (1985), defines profit as the total economic income of the entity after deducting wages and ground rents. Joseph Scumpeter defines profit as a surplus of income over cost. In the history of relative theories regarding profit, a special place must have Marx, who shows that the profit on selling a good is part of the value of that good. Heyne P. (1991) considers the profit as the difference between total revenues and total expenditures. In the author's opinion, total expenditure should include the so-called suppletive costs such as the owner's wage, the rent of the used building that is owned by the shareholder.

The accounting result has seen some developments over time. In the Stalinist period, in a Soviet-type economy, the accounting result was represented by the difference between sales, on the one hand and consumption and compensation of staff, on the other hand. Interest rates and taxes were not considered as expenses, but as result distributions. This concept of result was very logical given that most of the entities were the property of the state. In an economy of the

Yugoslav self-management type, in Tito's time, the entity's accounting result was represented by the difference between sales on the one hand, and the amount of costs, interest rates and taxes, on the other hand. The remuneration of the staff was not considered as expense because in a self-management type economy, where the owners of the entity were associated producers, it was not required to include the costs of their remuneration (Richard, 1996).

Taking into account the method of its calculation the accounting result is oriented towards the past, serving as a measure of the progress recorded by an entity during a period of time in the past. However, the accounting result may have other uses: a guide for the policy of dividends and for acquiring entity, a means of predicting future results in order to take investment or disinvestment decisions; a means of assessing the capacity of the management to run the entity; a means to assess the value of decisions taken by other groups related to the entity; a management tool in a number of areas inside or outside the entity as pricing policy, wage negotiations, credibility in front of credit agencies, price regulation under monopoly (Olimid, 1998).

The accounting result is the difference between total revenues and total expenses. The calculation of the accounting result is disclosed in the profit and loss account. The profit and loss account includes only the consequences of operational, normal activities for the period, and it reports on equity the activities that are not related to the operation. By the simple difference between revenues and expenses, the result is a partially elected date. Being oriented towards the past, the accounting result takes into account only the revenues and expenses, without allowing a forecast of future gains and losses. This disadvantage of the accounting result has led to another concept in accounting for measuring the performance of the entity: the comprehensive income. The comprehensive income is the relevant indicator that informs the entity's performance, because it takes into account not only past and present results but also the possibility of obtaining a favorable result in the future. The comprehensive income is calculated as follows:

The comprehensive income = Net income + Gains and losses directly recorded in equity

The calculation of the result of the year is disclosed in the profit and loss account and the calculation of comprehensive income is disclosed in the comprehensive income statement.

2. The profit and loss account or the comprehensive income statement?

A company obtains profit by carrying out two types of activities: those that combine or transform production factors into goods whose sale value is greater than the value of inputs and activities necessary to obtain some gains due to the increased value of production factors that are in the possession of the entity. The decisions arising from these two activities are so different that their separation is inevitable for assessing the fairness of management decisions. There must be a clear distinction between the change of the value resulting from production and the change of the value resulting from the passage of time (Edwards & Bell, 1961). The acquisition of any asset is considered a satisfactory investment as long as the present value of future cash flows generated by its use is higher than the present value of future revenues generated by the alternative use of the amount that would currently be obtained from the sale of the asset. No matter how fixed would be the intention to use an asset over a long period of time, it is wise that when a higher profitability opportunity is found, the asset should be sold and they should invest in another one. Thus, goods are purchased not only to take advantage of the margins from sales, but also to benefit from the expected changes in prices, be they general or relative.

Only the comprehensive income can be used to assess the performance of the entity and its managers (Chambers, 1994). To reflect this, we propose the following example: Suppose there are two companies with an initial capital of 4,000 mu. The accounting value of a land held by each of the two entities is 1,000 um at the end of year N, while its market value is 5,000 mu. During the year N, the companies recorded only expenses with the staff amounting to 3,000 um. The first entity makes the asset revaluation and the second entity sells the asset at its market value of 5,000 mu. In this case, we do not take into account the impact generated by the tax for profit. The gain from the revaluation of assets is not recorded in the profit and loss account but it directly affects the entity's equity .

The situation in the income statement is as follows:

	Company I	Company II
Revenues from the disposal of assets	0	5,000
Expenses on disposed assets	0	(1,000)
Staff costs	(3,000)	(3,000)
Net income	(3,000)	1,000

This happened because, for the first company, unrealized profits from the revaluation of assets have been recorded in equity without transiting the profit or loss account.

	Company I	Company II
Initial equity	4,000	4,000
Revaluation reserves	4,000	0
Net income	(3,000)	1,000
Final equity	5,000	5,000

If we were to calculate the variation of equity, we would obtain the same result, namely 1,000 mu. This variation reflects how the company enriched and reflects the indicator known as the comprehensive income. The comprehensive income statement is as follows:

	Company I	Company II
Gain from the sale of assets	0	4,000
Staff costs	(3,000)	(3,000)
Gain from the revaluation of assets	4,000	0
The comprehensive income	1,000	1,000

Then arises the question: Which one of the two entities is more powerful? Looking through the result of the profit and loss account, we would say that the latter is more powerful because it obtained profit. But it is not true because both entities enriched with the same amount, the former by increasing the land value and the latter by the gain obtained from the sale of the land. So both entities are equally powerful and the comprehensive income statement reflects this reality. That is why the comprehensive income tends to be the key indicator in assessing the performance of an economic entity.

3. A brief history on the rise of the comprehensive income

The term comprehensive income first appeared in 1980 in the American legal texts (SFAC 3). It took four years (SFAC 5) 1984 to clarify its content and its difference with the one of net income: "the comprehensive income is an extensive measure of the effects of transactions and of other events of an entity, that is, all changes in equity except for those resulting from contributions and distributions to owners" (Delaney P., 2003). If the definition of the concept required 4 years, its implementation required 13 years. SFAS 130/1997 establishes its application for the annual periods beginning after December 15, 1997. In terms of substance, the comprehensive income is presented as the sum between the net income (calculated and disclosed in the profit and loss account) and other gains and losses (provided as the totality of items charged against equity). In terms of form, the comprehensive income may occur either in the profit and loss account or in a statement of gains and losses or in a statement of changes in equity. However, in 1992 , ASB in the UK was the first regulator to adopt the concept of comprehensive income by the FRS 3 standard "Statement of total recognised gains and losses" (Ristea et al., 2006). This reflects the totality of profits and losses, rather found than achieved. In 1997, IASB revised the IAS 1 standard in order to introduce a second statement of the results regarding the changes in equity that may reflect either all changes in equity or changes in equity other than those related to the transactions with owners, an approach that has currently changed, as we present below. In 1998, the representatives of the Accounting Standards Council of Canada belonging to the ICCA participated together with the representatives of the standardization bodies in the U.S., New Zealand, Australia and Great Britain, as well as with the representatives of the IASB (this group of regulators is known as the G4+1), to the publication of a special report on a new disclosure of the performance (Jianu, 2005). The G4+1 proposal were mainly related to the presentation of the items of performance and not to the finding and the measurement of the performance. In other words, it was taken into account the manner in which specific items of performance were classified, grouped and presented in such a way as to serve the objectives of financial statements (to communicate information about the financial statement, financial results and cash flows of an entity, that are useful for a wide range of users).

4. The comprehensive income in the context of the international accounting convergence

According to the IASB framework, revenues are increases in economic benefits during the accounting period, in the form of increases in assets or decreases in liabilities, which have as a result the increase of equity in a way different from the increase coming from the contributions of the capital of owners (IASB, 2011). According to the international design the term *revenue* includes: revenues derived from the main activities of the entity; gains derived from auxiliary activities; gains from the increase of the economic value of assets or the decrease of the economic value of liabilities.

According to the IASB framework, expenses are decreases in economic benefits during the accounting period, in the form of outflows or decreases in asset values, or of increases in liabilities, which have the effect to reduce equity in a way different from the distributions for the benefit of the capital of owners (IASB , 2011). According to international design the term *expense* includes: expenses derived from the main activities of the entity; losses derived from auxiliary activities; losses from the decrease of the economic value of assets or the increase of the economic value of liabilities.

Only the first two items can be included in the profit and loss account. The last item is found only in the statement of comprehensive income. The comprehensive income includes the result determined in the profit and loss account as well as the gains and losses recognized directly in equity. The category of gains and losses recorded directly in equity includes: gains and losses from the revaluation of tangible and intangible assets, gains and losses from the valuation of financial instruments available for sale, gains and losses from hedging against the risk of cash flow, the differences in exchange from the conversion of foreign operations, actuarial gains and losses related to defined benefit plans. Thus, according to the IASB framework: The comprehensive income = Revenues - Expenses.

IAS 1 requires the economic entities, that starting from January 01, 2009, they should prepare the next set of financial statements as follows: the statement of financial position as at the end of the period; the statement of comprehensive income for the period; the statement of changes in equity for the period; the statement of cash flows for the period; the notes, comprising a summary of significant accounting policies and other explanatory information; the balance sheet at the beginning of period (when an entity applies an accounting policy retrospectively or when it reclassifies the items of financial statements).

According to IAS 1, an entity may disclose revenues and expenses of the period:

- in a single statement of the comprehensive income (here will be disclosed the incomes and expenses that are now reflected in the profit and loss account, as well as the gains and losses recognized directly in equity); or
- in two cases: on the one hand, the profit and loss account, and on the other hand, the statement of comprehensive income (here will be disclosed the net income that is calculated in the profit and loss account as well as the gains and losses recognized directly in equity).

5. Research methodology

Given the existence of two indicators for measuring performance: net income and comprehensive income, the central question of this study is to identify which of the two financial statements, which show the calculation of two indicators: profit and loss account or comprehensive income statement, is more important for investors. Given the option of listed entities which apply the international financial reporting standards to provide the calculation of comprehensive income in two different ways, we considered that choosing to prepare a single statement of comprehensive income is consistent with the orientation of investors to classify comprehensive income as the main indicator to measure the financial performance of an entity. Otherwise, if the entity chooses to present two financial statements for the calculation of comprehensive income, that is the profit and loss account and the statement of comprehensive income (the simplified manner), we found that investors consider the net result as the most important indicator to measure the financial performance.

Since 2009 was the first year when entities could choose to prepare a unique statement to reflect the financial performance of the entity, we have chosen to study the financial statements for 2009 for the economic entities listed on London Stock Exchange. Out of the 100 entities listed on London Stock Exchange (FTSE 100) we removed 29 entities due to lack of information transparency (the annual report for the year 2009 is not presented) and also 9 entities because: theree entity did not present the financial statements in the annual report, four entities presented financial statements prior to 2009 in their annual report, one entity applied the U.S. GAAP referential in its financial reporting, and one entity did not apply the amendments to IAS 1 for the financial year 2009 regarding the statement of comprehensive income. So 62 entities were surveyed.

6. Results

The financial year 2009 was the first year in which entities that apply IFRS can choose to present the economic entity's financial performance in a single statement of comprehensive income (here, it will be presented the income and expenses which are now reflected in the profit and loss account, as well as gains and losses recognized directly in equity), or in two situations: first, the profit and loss account, and then, the statement of comprehensive income (here, it will be presented only the total of the accounting income that is calculated in profit and loss account , as well as gains and losses recognized directly in equity). As seen in Figure 1, regarding the economic entities under study, we found that only 5 entities present a single statement of performance, while the remaining 57 entities prepare two statements of reporting performance: profit and loss account and the statement of comprehensive income.

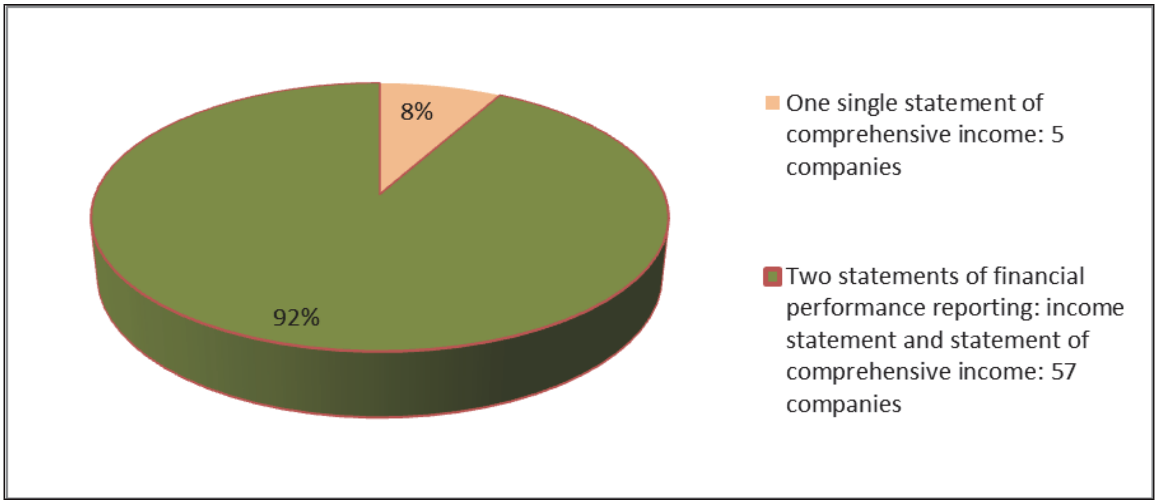

Figure 1. The distribution of financial statements reporting the number of performance.

As seen in Table 1, most economic entities obtain a positive comprehensive income. Four out of the eight entities for which comprehensive income registered a negative value, was generated by other comprehensive income (net income for these entities being positive) while for the remaining four entities, the negative value of comprehensive income was generated both by the negative net income and by the negative value of other comprehensive income.

Table 1. The influence of the net income ant other comprehensive income on the comprehensive income.

Comprehensive income	Net income	Other comprehensive income
54, Positive	23, Positive	23, Positive
	29, Positive	29, Negative
	2, Negative	2, Positive
8, Negative	4, Negative	4, Negative
	0, Negative	0, Positive
	4, Positive	4, Negative

The two entities who had a negative result, had a positive comprehensive income because the other comprehensive income were higher than net income. The four entities who had a positive result, had a negative comprehensive income because the other comprehensive income were higher than net income. Therefore, for six of the entities reviewed, other comprehensive income was at the basis of changing the sign of the comprehensive income (negative comprehensive income mai mare decât positive net income or positive comprehensive income mai mare decât negative net income), which represents less than 10% of the total number of entities reviewed.

According to IAS 1, the components of other comprehensive income include:

- (a) changes in revaluation surplus (IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets);
- (b) actuarial gains and losses on defined benefit plans recognised in accordance with paragraph 93A of IAS 19 Employee Benefits;
- (c) gains and losses arising from translating the financial statements of a foreign operation (IAS 21 The Effects of Changes in Foreign Exchange Rates);
- (d) gains and losses on remeasuring available-for-sale financial assets (see IAS 39 Financial Instruments: Recognition and Measurement);
- (e) the effective portion of gains and losses on hedging instruments in a cash flow hedge (see IAS 39).

The number of entities that have the elements of the gains and losses recognized in equity is presented in Figure 2.

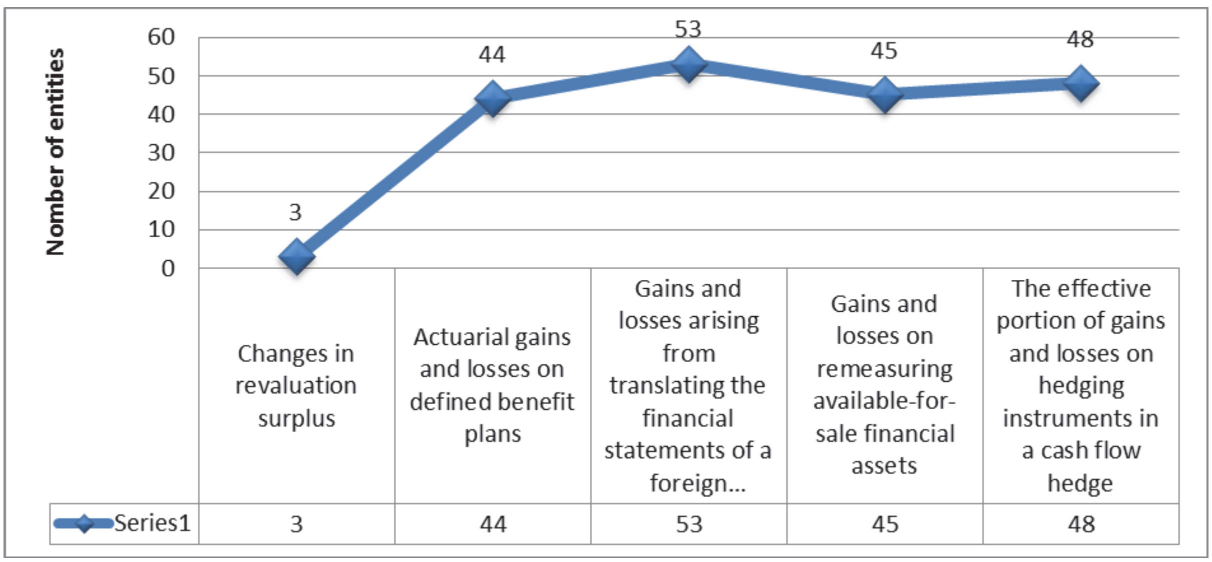

Figure 2. The number of entities that present other comprehensive income.

Changes in revaluation surplus

Now, more and more items are measured at fair value, property, plant, equipment and intangible assets are among the first items for which IASB allowed fair value measurement. Entities may proceed to the revaluation of tangible assets existing at the end of the financial year, so that they should be recorded at fair value in accounting and reflect the results of this revaluation in the financial statements for that year. Fair value is determined based on assessments usually made by qualified professionals in the assessment, members of relevant professional body that are recognized nationally and internationally. The items in a group of tangible assets are simultaneously revalued in order to avoid selective revaluation and reporting in annual financial statements of values that are in a combination of costs and values calculated at different times. If an asset is revalued, all other assets of the group to which it belongs must be revalued. The value differences found between the fair value and the accounting value of revalued items are recorded in the revaluation reserves in equity. It is surprising to note that out of the 62 analyzed entities, only 3 were appealed to the revaluation of tangible and intangible assets, knowing that in the UK the measurement at the current cost is a current practice.

Actuarial gains and losses on defined benefit plans

An entity should recognize a percentage of actuarial gains and losses as revenues or as expenses if the cumulative unrecognized net actuarial gains and losses at the end of the previous reporting period exceed the greater value between:

- (a) 10% of the present value of the defined benefit obligation at that date (before deducting plan assets); and
- (b) 10% of the fair value of plan assets at that date.

These limits will be calculated and applied separately for each defined benefit plan. If actuarial gains and losses do not exceed 10%, the entity may proceed with their systematic recognition in the statement of comprehensive income. 44 out of the 62 analyzed entities present actuarial gains and losses in the statement of comprehensive income.

Gains and losses arising from translating the financial statements of a foreign operation

Entities that prepare consolidated accounts whose subsidiaries are foreign entities must convert the financial statements of subsidiaries by using one of the two conversion methods allowed by IAS 21: the closing rate method or the historical rate method. Choosing the conversion method is done according to the functional currency of subsidiaries. The functional currency, defined as the currency of the primary environment in which the entity operates, is the currency used for valuation of the current assets, liabilities and transactions of the entity. The presentation currency is the currency used for the presentation of financial statements. For each of its entities, a group must identify the functional currency and convert the financial statements of these entities into the presentation currency chosen by the group. Usually, the functional currency of a foreign subsidiary is either the local currency or the currency of the parent-company. If the functional currency is the local currency, the conversion of the items of the financial statements of the subsidiary is done using the closing rate. If the functional currency is the currency of the parent-company, the conversion of the items of the financial statements of the subsidiary is done using the historical rate. The use of the exchange rate at the end of the year for the conversion of the items in the balance sheet, except for equity, may be equated to the valuation at fair value, and the trend of the IFRS is to recognize the variations of fair values in equity. Because exchange rate fluctuations affect the company's financial performance, regardless of the method adopted, the conversion differences are found in the statement of comprehensive income or in the net result, if the historical rate method was used, or in the gains and losses, if the closing rate method was used. 53 out of 62 analyzed entities present in the statement of the comprehensive income gains and losses arising from translating the financial statements of a foreign operation.

Gains and losses on remeasuring available-for-sale financial assets

Loans and receivables as well as investments held to maturity are valued at amortized cost and subject to testing for impairment. However, financial instruments held for trading and available-for-sale financial instruments are valued at fair value, but the changes in fair value are recognized differently, in the profit and loss account for those held for trading and in equity for those available-for-sale. Depending on the method to classify these financial instruments, the users' decisions that take into account the result in the profit and loss account in the analysis of the company's performance, may be significantly affected. Here is another argument, for which performance must be analyzed in terms of comprehensive income statement which includes gains and losses recognized directly in equity. 45 out of the 62 entities analyzed showed gains or losses recognized directly in equity, as a result to financial instruments available for sale that are held by the entity.

The effective portion of gains and losses on hedging instruments in a cash flow

The cash flow hedge covers the exposure to risks regarding the changes in cash flow associated with: a recognized asset or liability, such as future payments of interest that are related to a variable rate bond; a very probable transaction, such as an anticipated purchase or sale of stocks; currency risk for a firm commitment, such as a contract to buy or sell an asset at a fixed price, in the reporting currency of the company. For this situation, we will present the hedge accounting and its influence on the performance of the entity. A part of the gain or loss for a hedging instrument, considered to be an effective hedge[1] is recognized directly in equity and the ineffective part[2] in the profit and loss account. If the hedged anticipated transaction gives rise to the recognition of a financial asset or of a financial liability, the associated gain or loss, previously recognized in equity, must be transferred to the profit and loss account. If anticipated hedged transaction gives rise to the recognition of an asset or of a non-financial liability, the associated gain or loss previously recognized in equity, must be transferred to the profit and loss, or must be removed and taken into account in the initial assessment of the cost of acquisition or of the liability. An entity shall adopt one of the options presented and will apply it consistently to all hedges against risks. For cash flow hedge that does not give rise to an asset or a liability, the gain or loss from equity shall be recognized in the profit or loss account when the transaction takes place. 48 out of the 62 entities analyzed lead a hedging accounting.

7. Conclusions

In accounting, the evaluation of the performance is carried using the comprehensive income that includes changes in equity, due to the transactions and events in the period, other than those resulting from the transactions with owners. Although the concept of comprehensive income appeared firstly in 1980 in U.S. in the accounting rules, 27 years were necessary for this concept to be recognized internationally, by adopting the concept in IAS 1, revised in 2007. We consider the transition from the accounting result to the comprehensive income to be a shift from the historical cost evaluation valuation to the fair value evaluation, that is, from the abandonment of

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[1] Hedge is considered effective if, at the beginning and throughout the duration of the coverage contract, the entity can expect that changes in fair value or cash flows of the hedged item to be fully offset by changes in the hedging instrument and the actual results to be between 80-125%.

[2] Also, a coverage is ineffective if the hedging instrument and the hedged item are denominated in different currencies ranging reversely. Moreover, to hedge the interest rate risk by using a derivative instrument is not fully effective if part of the change of the fair value of the hedging instrument is due to the credit risk of the other part.

the concept of the past and present result to the concept of performance, which gives the future perspective of the entity. We shall see how long it will take until the concept of comprehensive income and its importance will be known also by practitioners, given that at present, even the financial analysts have not mastered this concept yet.

By analyzing the financial statements of entities under study, it has been observed that most entities prepare two financial statements to report performance (profit and loss account and statement of comprehensive income) although IAS 1 recommended as basic treatment the presentation of a single performance reporting statement. Following the achieved study by analyzing the yearly reports for the financial year 2009 for 62 entities listed on LSE, it was noticed that only 5 companies presented a single statement of performance reporting, that is, the comprehensive income statement. According to IAS 1, the components of other comprehensive income include: changes in revaluation surplus; actuarial gains and losses on defined benefit plans, gains and losses arising from translating the financial statements of a foreign operation; gains and losses on remeasuring available-for-sale financial assets; the effective portion of gains and losses on hedging instruments in cash flow hedge. The components of other comprehensive income are found in most entities analyzed, except for the changes in revaluation surplus that arise only in 3 entities that suggest the preference of entities regarding the historical cost evaluation for fixed assets.

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