CAN WE TRUST ACCOUNTING RESULT AND CASH-FLOW IN APRECIATING FINANCIAL PERFORMANCE?

MIHALCEA Mihaela Maria, HADA Izabela Diana
Department of Doctoral Accounting Studies, „1 Decembrie 1918" University of Alba Iulia, Romania
miha.ela_89@yahoo.com
izabela_hada@yahoo.com

Abstract: *Is profit an indicator that reflects the real performance of the economic entity? Or is it rather a benchmark for uninitiated users who do not know the artificial effects of policies, options and accounting estimates on this sensitive indicator? The vulnerability of the accounting result makes us focus on the objective nature of cash flow, which is a more modern and tangible measure of performance, eliminating the effects of using different accounting treatments for the same transactions. Corroborated, the two coordinates - the accounting result and the cash flow, and more specifically those related to the operating activity - would give a better appreciation of performance. What should we understand when these indicators contradict each other? Is that possible? The case outlined in this paper demonstrates that the answer is yes. But why does this happen and how do we appreciate the performance in this case? The present paper begins by presenting some beliefs that profit is an important indicator of financial performance. These are to be combated by presenting profit margins as an indicator of financial performance, the main or the disadvantage being its subjective character. Subjectivity does not apply to cash-flow, which leads us to say that the cash-flow reflects more objectively and more accurately the financial performance of the economic entity. Further, we will analyze the two indicators in parallel and comparatively, explaining the discrepancy that may arise between them and especially the situation where the profit is positive and cash-flow is negative. Our research is both empirical and theoretical. The results of this research point out to shareholders that profits can be misleading and recomend them to make a minimum simple comparison between proft and cash-flow, between operating profits and cash-flow from operations before they risk making decisions. Increased attention should certainly be given to the situation where there is a discrepancy between the two indicators, because according to some opinions it may even be a sign of the use of creative accounting, and practice has put us, not least, in the face of bankruptcy companies with huge profits.*

Keywords: *financial performance; profit; cash flow; operating activity; shareholders; creative accounting.*

JEL Classification: *M41; M42.*

1. Introduction

Performance is the primary objective of economic entities and the benchmark of all interested parties.
But financial performance and profitability are not equivalent terms. Given that we could rely on the unaltered qualities of financial-accounting information, in the good faith of the parties that could influence this indicator, profit could be a measure of

performance. But the techniques of profit manipulation are many and tempting. Therefore, viewed only through the accounting result, the performance presented may be misleading. This is why specialists are trying to redirect their attention to cash flows that are generated by concrete transactions. More accurately, cash flows from operating activities would be even more relevant as it reflects the entity's ability to finance its current business from domestic sources.
In addition, it is recommended to compare them with operating profit, a comparison that helps us to shoot a large alarm signal.
The content of the paper will analyze the weaknesses and strengths of the two indicators and will capture in a practical case the opposite image of their performance and, comparatively, their chaotic evolution.

2. Literature Review

There are many points of view, among the most well-known, that profit is an indicator, if not the "main indicator of measuring the financial performance of the entity" (Chirilă, 2004, Tulvinschi, 2013). Petrescu (2005), Ristea (2013), Stancu, I., Stancu, D. & Oproiu, A. (2013), Achim & Borlea (2012) also view performance through profit and other indicators based on profit.
On the other hand, Feleagă, N. & Malciu, L (2002), Colasse, B. (Tabara, N., 2009), Munteanu & Zuca (2011) find faults for this indicator, stating that the "result may be a convenient one but not necessarily true" and "profit is what the accounting calculates" and it does not accurately reflect the real situation of the entity.
Dinu (2017) and Ivan (2015) redirect users' attention to the cash flow statement. Popa, Kiss & Sziki (2012), Dănescu & Rus (2014), Herţeg (2013), Feleagă (1996) and Girbina & Bunea 2008 find cash flow more objective in appreciating performance.
Achim & Borlea (2012), Ivan (2015) signal the possibility of manipulating figures when there is a large discrepancy between the accounting result and the cash flow. All these ideas will be analyzed analytically in the paper.

3. Research Methodology

The purpose of this paper is to present comparatively the performance seen in terms of profit, respectively from the point of view of cash flow. In this sense, we sought to bring arguments for and against the two approaches - arguments from specialized literature, arguments from an analysis and interpretation of the norms in the field, as well as arguments obtained by the practical approach of a concrete case. The chosen case presents the values of gross profit, operating profit and cash flow related to operation, investment and financing activity for a period of 5 years for an economic entity listed on the regulated market of the Bucharest Stock Exchange. Conclusions are based on comparative analysis and the evolution of these data.

4. The Accounting Result - Indicator for Uninitiated Users?

There are many points of view, among the most well-known, saying that profit is an indicator, if not the "main indicator of measuring the financial performance of the entity" (Chirilă, 2004, Tulvinschi, 2013). Here are some quotations that support this statement:

- “The company's ability to achieve profit” reflects its performance (Petrescu, 2004/2005);
- “Profit is frequently used as a measure of performance”, as advocated by the Conceptual Framework for Financial Reporting, and also by practice;
- Conceptual Standard 1 (paragraph 43) states that “the most important part of financial reporting is the performance information of an entity provided through the comprehensive result and its components”.

We do not contradict these views in the circumstances in which we could rely on the unaltered qualities of the financial-accounting information, on the good faith of the parties that could influence this indicator. A slightly more cautious assertion restricts the universality of the foregoing, emphasizing the terms “as a rule” and “in a narrow sense”: “As a rule, in a narrow sense, performance is defined through profit / loss” (Ristea, 2013). “In a narrow sense” - because a single indicator is not relevant in assessing performance, a number of indicators and information have to be taken into account. But still profit is the one used in calculating many other indicators by which the performance of an entity is assessed, as summarized in the following table.

Table 1. Indicators calculated based on profit

	Indicator	Formula
Absolute values	EBIT Earning Before Interest and Taxes	Gross profit + interest expense
	EBITDA Earning Before Interest, Taxes, Depreciation, Amortization	EBIT + depreciation + amortization
	EVA Economic Value Added	Operating result - Income tax - Cost of invested capital
	CAF Self-financing capacity	Net result for the year + interest expense + depreciation + amortization; EBITDA - Profit tax
Relative values	ROE – Return On Equity	Net result / Equity x 100
	ROA – Return On Assets	Net result / total assets x 100
	EPS – Earning per Share	Net result / number of shares

Source: Own editing

Regarding these indicators, the following explanations are made that also reinforce the fact that the result, on the basis of which they are calculated, is considered a benchmark in the performance appraisal:

- “Since the launch in 1989 by Stern Stewart & Co, EVA (or economic profit, conventionally used term) is the most used indicator (...) for measuring enterprise performance” (Stancu, 2013), “EVA is a measure of the real economic performance of society, serving primarily the interests of managers” (Achim, 2012);
- The EPS indicator has a “significant impact on the share price and, therefore, an important role in substantiating investor decisions” (Achim, 2012);

- “ROI and ROE are the ones expressing an adequate measure of performance” (Stancu, 2013).

However, performance “must not be sought exclusively in the profit and loss account” (Feleagă et al., 2002), because “the outcome may be convenient and not necessarily true” (Munteanu and Zuca, 2011) and “profit is what accounting calculates” and does not accurately reflect the real situation of the entity (Colasse, 2009). How else, on the basis of the same events, the same data, could be achieved different results by applying different accounting policies, different accounting references?

Table 2. Policies and accounting options with effect on the accounting result

Policies and accounting options for fixed assets	▪ Recognition of an asset - valuation at the entrance to the patrimony; ▪ estimation of residual value; ▪ Choosing the amortization method (linear, accelerated, digressive) ▪ estimation of the normal use time; ▪ recognizing a modernization or repair; ▪ revaluation of fixed assets.
Policies and stock options	▪ valuation at the patrimony entry (inclusion or non-inclusion of costs in the acquisition cost); ▪ choosing the method of stock valuation at the exit from the patrimony (at the end of consumption)
Registration of construction contracts	
Borrowing costs for long-term produced assets	
Development Expenses Capitalization Policy	

Source: Own editing

Considering all these influences on the accounting result, we conclude that this indicator is vulnerable and sensitive and does not objectively reflect the performance of the economic entity. Profitability is therefore a (more or less) necessary condition, but “not enough to avoid financial difficulties” (Dinu, 2011). Therefore, “the attention of users of financial statements must be redirected, in the sense that they do not have to give excessive weight to the accounting result” (Ivan, 2015).

Companies, after all, go bankrupt because they can not pay their debts, not because they are unprofitable. It is obvious that liquidity is important. Even so, “many investors usually ignore it. How? Looking only at the company's profit and loss account and not the cash flow statement” (Moreland, 1995). Or “the cash flow analysis has become an imperative need to complete the analysis of an entity's financial condition because it has always been proven that the existence of an accounting profit is also a guarantee for ensuring the ability to pay and avoiding the risk of bankruptcy in this way”. An example would be the collapse of W. T. Grant Company with profits, but negative cash flows (Mills & Yamamura, 2000). And the company analyzed in this paper is molding on the positive result - negative cash flow model. On the other hand, “an accounting loss does not necessarily mean a default and planning a bankruptcy risk” (Achim, 2012). We want only “a change in the perspective of the users” (Ivan, 2015), pointing their attention to the cash flow situation, which is the “modern instrument of performance measurement” (Popa et al., 2012).

5. Performance Assessment Based on Cash Flow

The cash flow statement is mandatory for entities of public interest and for medium and large entities that, at the balance sheet date, exceed the limits of at least two of the following three criteria (OMFP 1802/2014):

a) total assets: EUR 4 000 000;

b) net turnover: EUR 8 000 000;

c) average number of employees during the financial year: 50;

and optional, but useful for small, unlisted entities, because “such a well-established situation allows the taking of useful information in the decision-making process regarding the negotiation of the terms of receipts and payments in order not to get into the situation of inability to pay” (Dănescu, 2014). The treasury provides key information as it is the source from which the entity finances its activity and secures its future (Ciuhureanu et al., 2009). “The ability of the entity to generate cash or cash equivalents” depends on “its ability to pay its employees, suppliers, creditors and to pay capital” (Todea, 2009). The entity's ability to pay is of real and direct relevance to all parties involved: investors are interested in dividends, staffing - timely payment of wages, suppliers and other creditors - to timely and full reimbursement of the debts that the entity has, the state - to have taxes payed, and managers are interested in dealing with all these debts.

Herţeg (2013) appeals to the “objective nature of cash flows”. In the same assertion, Feleagă (1996) considers that cash flows are “concrete phenomena”. “Profit is a point of view, while money is a reality” (Gîrbină, 2008). Therefore, the cash flow situation can not be easily manipulated, as it is not influenced by the accounting policies adopted (Popa et al., 2012), eliminating the effects of using different accounting treatments for the same transactions and events and increasing the comparability of different entities (IAS 7 Statement of Cash Flows).

In reporting treasury flows, the “juggling” that can be made refers to the categorization of a cash-generating operation in one category or another. Thus, flexibility stems from the possibility of classifying an operation into one of three categories: operation, financing or investment. Treasury flows from exploitation should have the most significant weight because “their level depends also on the company's ability to generate sustainable results” (Ivan, 2015).

Desiring to present an efficient operational activity, economic entities tend to classify positive flows as current and negative ones as inaccurate, international standards and regulations in our country permitting such interpretations in respect of interest paid and interest rates, and dividends received which, according to IAS 7 *Statement of Cash Flows*, also taken over by OMFP 1802/2014, can be classified as operating cash flows as they are included in the determination of profit or loss.

In principle, a sharp and consistent increase in cash flows from financing activity should be in the final balance or offset from the investment activity, otherwise it would mean that the operating activity can not be self-financing and is not, therefore, profitable in terms of cash generation.

Cash flows can be manipulated by such reclassification methods supported by creative but logical explanations, or can be distorted by actual actions that at one point can have a major influence on cash availability. Sales of receivables, lease-backs, bank loans, fictitious loans from affiliates, deferment of a payment have a positive influence on the treasury.

The importance of cash flows from operating activities is also supported by a study by Livnat and Zarowin (1990) concluding that “the components of operating and financing cash flows are directly and significantly associated with return on market shares, but not the same can be said about the cash flows related to the investment activity” (Ştefan, 2016). Also, a study by Jones and Widjaja (1998) among 157 Australian credit officers and financial analysts highlighted the increased relevance of cash flow for operating activities in decision-making relative to the activity of financing or investment. However, the examination of the investment activity is important to analyze whether the entity extends its activity or not, and further analysis of the financing activity provides information on how the entity finances its expansion or how it reduces its debt-related financing (Achim and Borlea, 2012).

6. Correlations between the Result of the Exercise and the Cash Flows

Comparing cash flow and accounting result, Ştefan (2016) estimates that “cash flows contain a higher degree of incremental information than earnings quantified through different forms of profit”.

“Starting from this relationship that is formed between the results and the cash flows, we try to find creative accounting practices”, due to “non-generating cash expenses and incomes, as well as the elements of assets and debts that defer receipts and payments” (Ivan, 2015), but we do not have to make hasty conclusions, as this difference occurs primarily on account of accrual accounting. However, comparing net cash flows with net profit “highlights the net profitability of generating cash” and determines the difference between “calculated and actual performance” (Achim and Borlea, 2012).

Howard Schilit (2003, 203) said in a study that by comparing cash flows with profit, we should get an alarm signal in the event of a large discrepancy. Reporting negative or small cash flows under a high operating result may give rise to suspicions about the quality of revenue and expenditure and may be a sign of the use of creative accounting. More specifically, “in order to detect the high incomes that do not bring cash, it is advisable to examine the relationship between cash flows from operating activities over a period of time and net income: if net income is positive, while treasury flows of the exploitation activity is negative, there is a likelihood of manipulation of the results by the leadership” (Ivan, 2015). However, the difference between operating cash flow and operating result after tax includes a normal component and one generated by the outcome management practices (Huian et al., 2018). So, not every difference is a sign of manipulation of the outcome.

Also, in order to detect the presence of the manipulation of the results, it would be useful to follow the evolution of the result and the cash flow from the operation activity. When the result increases by increasing revenue or decreasing spending, we also expect the cash flows from collecting the receivables that generated those higher incomes and the payment of the debts that generated those lower expenses to increase. If the result and cash flow of operating activity do not have the same trend, the signs of artificial transactions are obvious.

The table below presents values of the total result, operating result and cash flow components for a listed entity on the regulated market of the Bucharest Stock Exchange for a period of 5 years.

Table 3. The accounting result and the cash flow for the last 5 years for a listed company on Bucharest Stock Exchange (RON)

	2013	2014	2015	2016	2017
Gross profit	697.650	3.001.409	5.303.803	3.886.177	3.112.541
Operating profit	1.420.340	3.275.760	5.329.516	3.549.224	3.138.672
Cash flow	- 366.969	529.636	642.756	778.678	- 1.592.603
Cash flow from operating activities	- 487.692	2.068.452	3.890.329	3.948.046	349.349
Cash flow from financing activity	672.413	- 694.557	- 3.030.056	- 3.583.754	- 1.276.847
Cash flow from the investment activity	- 551.690	- 844.259	- 217.517	414.386	- 665.105

Source: www.bvb.ro

Table 4. Absolute profit / cash flow differences (RON)

	2013	2014	2015	2016	2017
Profit - Cash flow	1.064.619	2.471.773	4.661.047	3.107.499	4.705.144
Operating profit - Operating cash flow	1.908.032	1.207.308	1.439.187	- 398.822	2.789.323

Source: Own calculating

Table 5. Relative profit / cash flow differences

	2013	2014	2015	2016	2017
Profit / cash flow	-1,90	5,67	8,25	4,99	-1,95
Operating profit / operating cash flow	-2,91	1,58	1,37	0,90	8,98

Source: Own calculating

Table 6. Chain indicators

Chain indicators	2013	2014	2015	2016	2017
Profit		4,3022	1,7671	0,7327	0,8009
Operating profit / loss		2,3063	1,6270	0,6660	0,8843
Cash flow		-1,4433	1,2136	1,2115	-2,0453
Cash flow from operating activities		-4,2413	1,8808	1,0148	0,0885
Cash flow from financing activity		-1,0329	4,3626	1,1827	0,3563
Cash flow from the investment activity		1,5303	0,2576	-1,9051	-1,6050

Source: Own calculating

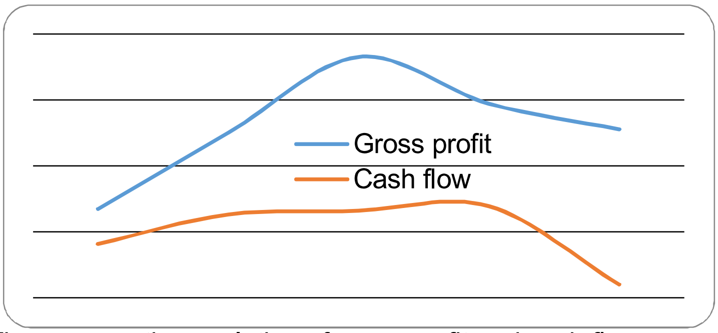

Figure 1. The comparative evolution of gross profit and cash flow
Source: Own editing

The absolute differences between profit and cash flow are substantial. In all five years the profit keeps much higher than cash flow, the differences being positive, except in 2016 when the operating profit is by 398,822 lei less than the cash flow related to the operation activity.
Significant differences are supported by the ratios calculated in the above table showing a return up to 8 times the cash flow in 2015. The differences are lower among these operating performance indicators until 2017 when the profit in operation records a value approximately 9 times higher than the cash flow from the operating activity.
We observe the figures presented in table no. 6, and better, in figure 1, a consistent, even opposite, difference between gross profit and cash flow that recorded negative values in the first and the last year. Profit is rising sharply by 2015, followed by a gradual decline by 2017. Growth is not as steep as cash flow, however, which has fallen in defensive from 2013, but declining in 2017 is far from profits.

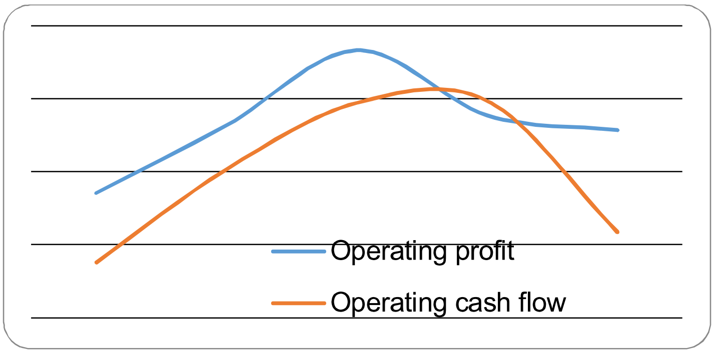

Figure 2. The comparative evolution of the profit and cash flow related to the operating activity
Source: Own editing

Operation activity shows roughly the same rhythm of profit growth and cash flow in the first two years, but the decline in 2017 has more impact on cash flow. Figure 2 is suggestive in this respect.
The parallel between the accounting result and the cash flows can also be seen from the perspective of the parallel between the accrual accounting and the cash

accounting. The overall conceptual framework advocates accrual accounting on the grounds that "information on economic resources and prices to a reporting entity as well as changes in its economic resources and claims to the entity over a period provide a more robust basis for assessing past performance and the entity's future than information relating only to cash and cash payments during that period." In other words, "treasury accounts provide only short-term information for the reporting period, without providing information about the past or future entity's commitments" (Dănescu and Rus, 2013). This does not, however, contradict the need to develop and analyze the cash flow situation which, as we have seen in the above analysis, shows us the performance from another perspective, attracting our attention in case of contradiction or offering, on the other, along with profitability, a more complex picture of financial performance.

7. Conclusions

Performance can be presented differently in terms of profit and cash flow. Because profit is often a matter of accounting choices, it is not the indicator that most faithfully reflects the entity's performance, which eventually reduces the entity's ability to generate cash to pay dividends to shareholders, employee salaries, supplier debts, taxes, and other State obligations. Obtaining profit is therefore a (more or less) necessary but not sufficient way to avoid financial difficulties.

The present paper is not intended to determine which of the two indicators - profit and cash flow - faithfully reflects performance, but to alert users that a single indicator is not sufficient for a complex performance analysis, given that choosing only two, the individual conclusions can be totally the opposite. Accrual accounting naturally determines a difference between the accounting result and the cash flow, but the cause of a large discrepancy could be the application of outcome management techniques. Therefore, especially in this case where the two indicators contradict, a more in-depth analysis of the performance and transactions that generate this discrepancy is recommended.

It is certain that financial performance and profitability are not equivalent terms. Profit may be at most a measure of performance, but before we hurry with a conclusion, we should also analyze the cash flow at least.

References

1. Achim, M.V., Borlea, S.N. (2012), *Analiza financiară a entităţii economice*, Editura Risoprint, Cluj-Napoca

2. Ciuhureanu, A. T., Balteş, N., Gorski, H. (2009), Managerial objectives of the annual financial statements. True and fair view or „Users, be careful!", *Annals of the University of Petroşani, Economics*, 9(1), pp. 165-172

3. Colasse, B., traducere de Tabara, N. (2009), *Fundamentele contabilității*, Editura Tipo Moldova, Iași

4. Conceptual Framework for Financial Reporting (2018)

5. Dănescu, T., Rus, L. (2014), Cercetări privind impactul modelului de contabilitate asupra performanței economico-financiare, *Audit financiar*, Vol. 12 Issue 116, pp. 20-28

6. Dănescu, T., Rus. L. (2013), Comparative study on accounting models cash and accrual, *Anales Universitatis Apulensis, Series OEconomică*, 15/2013/II

7. Dinu, E. (2011), Stabiliţi indicatori de performanţă managerială prioritar pe bază de cash, nu de profit!, în ediţia tipărită a *Ziarului Financiar* din data de 13.09.2011, disponibilă la adresa http://www.zf.ro/opinii/stabiliti-indicatori-de-performanţa-manageriala-prioritar-pe-baza-de-cash-nu-de-profit-8737150, data accesării 10.10.2018
8. Feleagă, N. & Malciu, L. (2002), *Politici şi opțiuni contabile – Fair acoounting versus bad accounting,* editura Economică, București
9. Feleagă, N., Malciu, L., Bunea, Ş. (2002*), Bazele contabilităţii: o abordare europeana şi internaționala,* Editura Economică, Bucureşti
10. Girbina M.M., Bunea S. (2008), *Sinteze, studii de caz şi teste grila privind aplicarea IAS (revizuite) – IFRS,* Volumul 3, Editura CECCAR, București
11. Huian, M.C., Mironiuc, M. and Chiriac, M. (2018), Study on the association between earnings management and value relevance based on the reporting method used for operating cash flows, *Audit Financiar*, vol. XVI, no. 1(149)/2018, pp. 101-110,
12. IAS 7 *Statement of Cash Flows*
13. Ivan, I. (2015), Ways to Detect Creative Accounting Techniques by Studying Cash Flows, *Audit financiar*, XIII, Nr. 8(128), pp. 94-102
14. Moreland, J. (1995), Difference between earnings and cash, *Individual Investor Magazine*, Individual Investor Group, Inc.
15. Munteanu, V., Zuca, M. (2011), Consideraţii privind utilizarea contabilităţii creative în denaturarea informaţiilor din situaţiile financiare şi „maximizarea" performanţelor firmei, *Audit Financiar*, Anul IX, nr. 3
16. OMFP nr. 1802/2014 pentru aprobarea Reglementărilor contabile privind situațiile financiare anuale individuale și situațiile financiare anuale consolidate, MONITORUL OFICIAL AL ROMÂNIEI, PARTEA I, Nr. 963/30.XII.2014
17. Petrescu, S., (2004/2005), Performance et risque dans l'analyse financière, *Analele științifice ale Universității "Alexandru Ioan Cuza" din Iași*, http://anale.feaa.uaic.ro/anale/resurse/16%20Petrescu%20S-performanţa%20si%20risc%20in%20analiza%20financiară.pdf)
18. Popa, D., Kiss, M., Sziki, K. (2012), Contemporary approaches of company performance analysis based on relevant financial information, *Annals of the University of Oradea, Economic Science Series,* Vol. 21 Issue 2, pp. 708-715
19. Ristea, M. (2013), Căutari şi regăsiri în excesul de reglementari contabile. Nevoia de actualizare şi uniformitate, *Revista Contabilitatea, expertiza şi auditul afacerilor,* nr. 2/2013
20. Schilit, H. (2003), *Financial Shenanigans. How to detect accounting gimmicks and fraud in financial reports*, ediția a 2-a, editura McGraw-Hill
21. Stancu, I., Stancu, D., Oproiu, A. (2013), Empirical study on the factors determininig the company's performance – DuPont system, *Audit financiar*, Vol. 11, No. 103
22. Ştefan, I.O. (2016), The implications of financial performance on stock exchange indicators of listed companies: empirical evidence for the Romanian capital market, *Audit Financiar*, vol. XIV, no. 8(140)/2016, pp. 875-896
23. Todea, N. (2009), Teorie contabilă şi raportare finaciara, Editura Aeternitas, Alba-Iulia