

MODELLING THE INCOME AND REFLECTING THE PERFORMANCE OF AN ENTITY

Ph.D. Student Viorica IDU (DINDAREANU)

“Valahia” University of Targoviste

E-mail: vicavica50@yahoo.com

Abstract: *The result of an entity is presented by means of some patterns that highlight the evolution in time of this concept. The new vision of the comprehensive income is shaped by the pyramid approach carried out by J.F.Casta and O. Ramond. The pyramid approach points out the difference between the operating income and the comprehensive one, by including the OCI component- a consequence of the use of the fair value measurements of some asset and debt items. There are also mentioned various patterns of the contents of the profit and loss account, according to the structure of the expenses, as a result of the nature criterion or the entity's functions one. There can be found as well patterns of the result's analysis by means of the direct costs and of the break-even point. The aim of the study follows the good knowledge of the advantages and the limits of the different ways of underlying the results.*

Key words: *result, performance, profit and loss account, comprehensive income, fair value, direct expenses, break-even point.*

JEL Classification: *M41.*

1. Introduction

The study conducted shows that determining the income of the entity can be considered an endeavor influenced by a large number of domestic and external factors of the company, its size depending on the tax and accounting policies. The subjectivism over the choice of policy, accounting practices, assessment or adjustment determines a certain size of the result. The latter's size can vary between certain limits without considering faulty any of these values.

The process IASB of capturing the performance of an organization by means of a single financial statement, has led to the expansion of the concept of the outcome. The expansion of the aim of the fair value application to the outcome and adding new elements to it (the component called Other components of the comprehensive income) has contributed to an increase of the volatility of the result by including some virtual elements which arise from the market developments. Thus, the income contains some value adjustments of the assets and liabilities according to the market value.

The presence of the options in accounting raises the question of the choice criterion of some fiscal policies. One can notice there is no objective result within the context of the international accounting standards that can offer a diversity of options for reflecting the same transaction. Choosing an option over the other can draw out a certain impact on the financial and accounting incomes. Beyond the impartial relationship of determining the income as a difference between the revenue obtained and the expenses incurred, the freedom to choose the fiscal policies determines either a decrease or an increase of the income according to targets previously assumed by the organization's management. In this respect, one can say that there is no accounting truth in determining the result.

2. Literature review

The normalization of a summary situation (financial reports) over the comprehensive result which is to replace or complete the traditional format of the results account has become a permanent concern within the joint project initiated by IASB and FASB with the view to achieving the convergence between the IFRS and US GAAP standards.

Most of the views related to the use of the presentation of the comprehensive income were delivered following the issue published by FASB of SFA S130 – The report

of the comprehensive result, standard which has been made compulsory beginning with the subsequent reports dated December 15th, 1997.

The authors O.Hanlon and Pope and Dhaliwal point out the fact that, regarding the assessment of stock yields, the comprehensive income, once compared with that shown in the net accounting income can rarely provide further information.

Quite by the contrary, Hirst and Hopkins, Maines and Mc Daniel, Biddle and Choi empirically claim the decision- making relevance of the comprehensive income. At the same time, one cannot rule out the fear that some elements, which at present do not belong to the result account, by being included in the comprehensive income, might be provided with an informational value far above their real level of meaning.

Once SFAS 130 has been issued, both at the IASB and FASB levels, the problem of the comprehensive income has evolved, being closely related to the treatment of the differences from the fair value measurement (for example the result of the re-evaluation of the fixed assets IAS 16, of accounting the gains and losses from investing in overseas entities – SFAS 52, IAS 21, of the unrealized gains and losses related to the financial tools available for selling- SFAS 115, IAS 39).

Therefore, the fair value becomes a fundamental tool of evaluation of the financial performance, taking into account the fact that by its use some accountancy flaws can be corrected into historical costs, being often incriminated for the differences between the reported values and the economic reality. In this case, an asset can generate incomes by increasing its fair values since the decision of holding an asset draws out economic consequences that the financial circumstances can undergo, thus the outcoming generated income should be relevant in assessing the resources management.

From this point of view, the new concerns about the performance presentation and the comprehensive result reflects the difficulty of disassociating the resulting income flows from the operational activity, from the income streams resulting from the changes in balance sheet values.

3. The research methodology

Finding out the answers to the study's aims has been carried out through a theoretical research, by means of which it has been accomplished the analysis of the process of implementation of the international standards of financial reporting in compliance with the European accounting directives, being filled in through an application form in which there have been stressed out examples and schemes that are related to the problem addressed.

The starting point of the research was the theoretical documentation by covering the literature particular to the field and the evolution of the accounting regulations. This fact has actually led to making statements and to a clear structure of the elements regarding the income of the entity and its relation. It comes out that this thing was able to be achieved in the context of the various accounting differences: international, European and national. Such an approach has meant to highlight the understanding the conceptual set of reporting the company's results by means of the financial situation.

The bibliographic documentation has been achieved by using sources such as: research work carried out on the topic discussed both from the national literature and the international one, regulatory requirements of national and international accounting regulatory institutions.

The study focused also in producing bibliographic handouts for summing up the information, literature translations, and data processing. There have been consulted databases for indexing the research work in the field.

4. The income and the performance of the organization

According to a first approach (figure no.1) , “an organization is successful if it is at the same time productive and efficient” (Niculescu, 1997), its productivity representing the ratio between the results obtained and the means committed to achieving the results and the efficiency representing the balance between the results achieved and the expected results.

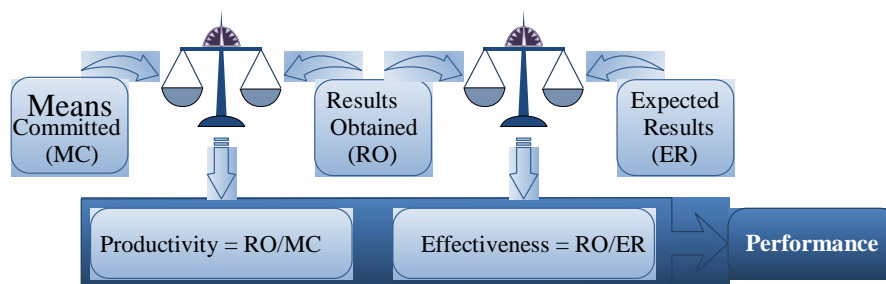


Figure no. 1. The performance – the first approach

Source: author’s design

The increase in the labour productivity is not enough for assuring an organization’s performance. The productivity must be analyzed in a strong connection with its efficiency. “If the industrial system continues to hold a single objective – the productivity , it will be heading to disaster” (Niculescu, 2003). Therefore, it turns out that an organization is theoretically performant when it is at the same time productive and efficient. For achieving its goals, the organization spends more resources most of which have been obtained through debts. The efficiency of using such resources plays a significant part for the result obtained by the organization.

From another point of view, three notions can be associated to the basic concept (figure no. 2): the economical aspect(getting the necessary resources at their lowest price), the efficiency (maximizing the results achieved, starting from a specified amount of resources, either minimizing the amount of resources for a predetermined income) and efficiency (the results obtained should reach the expected results) (Ristea, 2001).

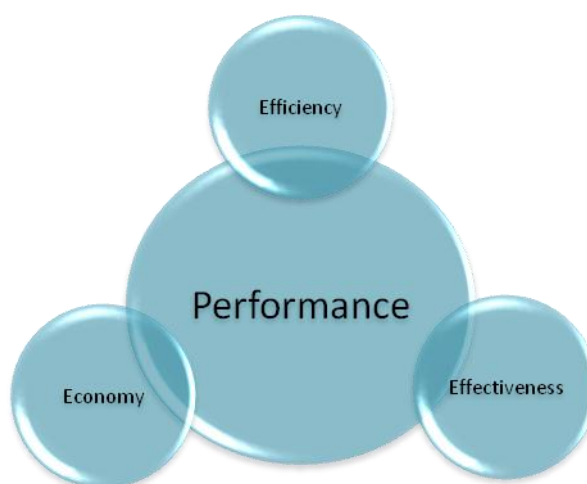


Figure no. 2. Performance – the second approach

Source: Author’s approach

In this respect, according to N. Feleaga, L. Feleaga and S. Bunea, a significant indicator related to performance should offer the possibility of comparing the effect obtained with the effort made for its accomplishment (Feleaga, Malciu and Bunea, 2002).

Over the years, the assessment criteria of the performances of an organization have been in a constant movement. G. Lavalette, M. Niculescu define the performance *as an unstable level of potentiality, being accomplished by everything that has been optimized by the worth- cost association and it has made the organization competitive in its strategic segments* (Lavalette and Niculescu, 1999). From this point of view, performance is synonymous with competitiveness. An organization is competitive, that is, well-functioning, when the levels of effectiveness and efficiency obtained ensures it a sustainable presence on the market.

The measurement of enriching the shareholders (value creation) can be fulfilled as well by means of the notion of economic value added. (EVA- Economic Value Added). Through this notion one ensures the domestic performance measurement of the organization) (Hoarau, 2008). The value added takes into account the whole cost of the capital used. The value of this indicator is influenced both by the costs of the equity ratio and by those of the borrowed one). Taxation has a direct impact on the equity ratio and the borrowed capital. The way of calculating EVA was initiated by Stern- Stewart cabinet, and it is the following one:

Economic Value Added (EVA) = Operating Net Income – Cost of the employed capital

$$\text{Economic Value Added (EVA)} = \text{RE} \cdot (1 - \text{T}) - \text{K} \cdot \text{CE}$$

RE = Operating profit
T – Corporate Tax Rate
K – The average cost of financial resources (equity capital and debts)
CE – Economic capital

Figure no. 3. Determination of EVA, after Bernard Colasse

The calculation of EVA as measuring the difference between the operating income after taxation and the remuneration of the economic capital used by the organization can also be found in the works of B.Colasse, the formula used is that shown in the figure no. 3 (Colasse, 2008).

If EVA registers a positive value, one can state that there has been created a well-offness state for the shareholders of the organization. If EVA has a negative value, it means that the operating result does not cover the cost of the capital invested.

For determining the economic value added, one must explain the notions of the invested capital and the net operating profit after taxation. The result of the operation is a concept that needs to be explained since it has different variants nowadays. The net operating profit is what in the French literature is called “*resultat d’exploitation après impôt*”, respectively “*Net Operating Profit after Taxes- NOPAT*”, in the English literature. The operating profit after tax is determined on the basis of the calculus:

$$\text{The operating profit after taxation} = \text{The operating profit} \cdot 1 - \text{Corporate tax rate}$$

The notion of operating income after taxation considers that the organization is financed from its funds only, and it lacks financial expenses by paying a tax only on the operating profit, without benefitting from the tax reduction corresponding with the interest

charges. An organization will hold the same operating profit after taxation, regardless of its financial structure. The economic value added can be obtained by minimizing the operating profit after taxation with the costs of the invested capital, which is determined on the basis of the following calculus:

Expenses related to the invested capital = Invested capital * The average capital cost

C. Hoarau defines the *cost of the invested capital as the weighted average cost of the resources made available to the organization by its financiers: the shareholders and creditors* (Hoarau, 2008). The invested capital comes out from the equity capital and from the financial debts the economic asset is financed from (borrowed capital). From the creditors' point of view, the cost of the capital (figure no.4) is an opportunity cost which represents a revenue loss that results from a specific allocation of the available resources.

DF * D * (1-T) The borrowed capital cost
DF – financial debts
D – interest rate
T – income tax rate

Figure no. 4. The cost of the borrowed capital; source: author's conception

The cost of the equity capital is not reflected in the results account, the accounting result being affected only by the cost of the borrowed capital. The equity capital does not represent a free source of financing, the shareholders claiming remuneration on the basis of the risk assumed. The determination of the cost of the equity capital is carried out starting with the model CAPM (Capital Asset Pricing Model) which was developed by Markowicz, Sharpe.

$$R = R_f + \beta \times (R_m - R_f)$$

Where:

R- return on equity

R_f= the risk-free financial rate

β - volatility coefficient of the securities compared to the average of the stock market

R_m= the average return on equity of the stock market

The difference (R_m and R_f) stands for the stock market risk premium. By replacement in the model equation CAPM, it results:

$$R = R_f + \beta \times \text{the risk premium}$$

For determining the equity cost in currency units in the previous formula, each term is multiplied by equity (expressed in cash terms), leading to the following formula for determining the cost of the equity capital:

The average cost of capital shall be determined according to the following calculation formula:

$$\text{Equity capital} \times (R_f + \beta \times \text{Risk premium}) \quad \text{The equity capital cost}$$

$$CM_K = \frac{(C_{Kp} + C_{Ki})}{(K_p + K_i)}$$

Where:

CM_k= the average cost of capital

C_{kp}= the equity cost

C_{ki} = the cost of borrowed capital

K_p= equity capital

K_i= borrowed capital

5. The concept of output in IASB's vision

In 2003, IASB and FASB initiated a joint project regarding the financial situation which brought out the concept of result back to the debate. The first stage of the project resulted in revising the rule IAS 1 *Presentation of the Financial Statements*. There were introduced new concepts regarding the output. In the new vision, the outcome (figure no. 5) was extended by adding to its classic elements (profit or loss) a new component called Other components of the comprehensive result. (“*Other comprehensive income- OCI*”). This new component includes income or expenses which do not belong to the income, but which are allowed by certain rules of the international accounting reference.

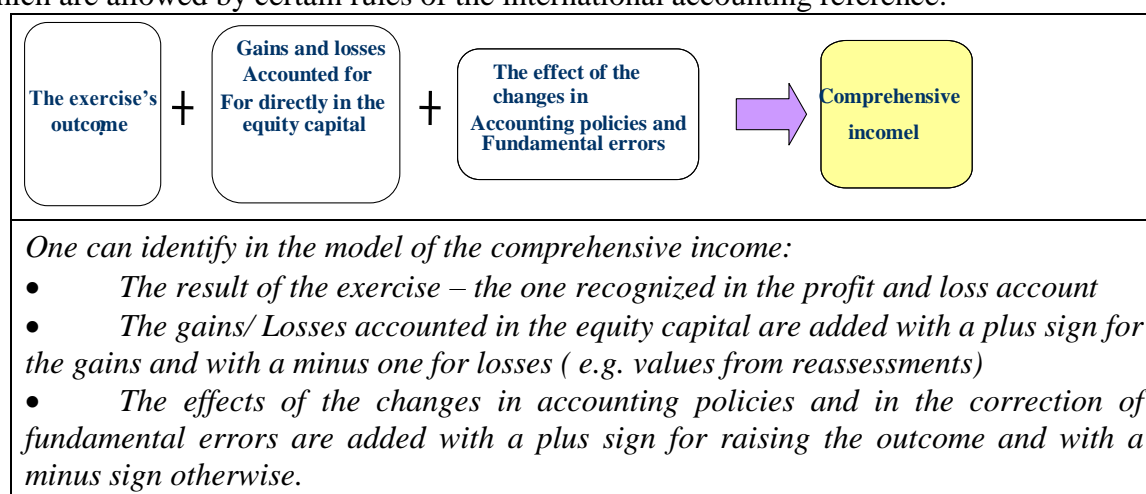


Figure no. 5. The comprehensive income according to IASB, source: author's conception

In the pattern of the comprehensive income, one can identify both the gains and the losses coming out of the course of the organization's activities. Even if these elements meet the definition of gains and expenses elements, the international standards of financial reporting consider its presentation in the Statements of equity as being appropriate, and not directly within the Gains and losses account. This way of approaching the income of the organization has entirely changed its former concept. The OCI component of the comprehensive income can be regarded as a consequence of using some asset and debt items at fair value. The concept of the comprehensive income appeared within the IASB's wish to capture the organization's performance through a single financial circumstance. Such an approach of IASB represented also a step of getting near the FASB standards which held a previous tradition in appreciating the performance by means of the comprehensive income. Under the circumstances, IASB together with FASB represent a partnership which was aimed to identify the best solution of including the comprehensive income in the financial statements. J.F.Casta and O.Ramond , getting inspiration from US

GAAP – SFAS 130 *Reporting of the Comprehensive Income* represents a pyramid approach of the comprehensive income (figure no. 6). The consequences of the operational activities from the period are covered in the gains and losses account too. Under the circumstances of changing the equity capital one includes the gains and losses from reevaluating the property investments, the gains and losses from the evaluation of the the financial tools available for selling , the gains and losses from covering the risks associated with the cash flow and the investments from an external entity, a.s.o. (OCI).

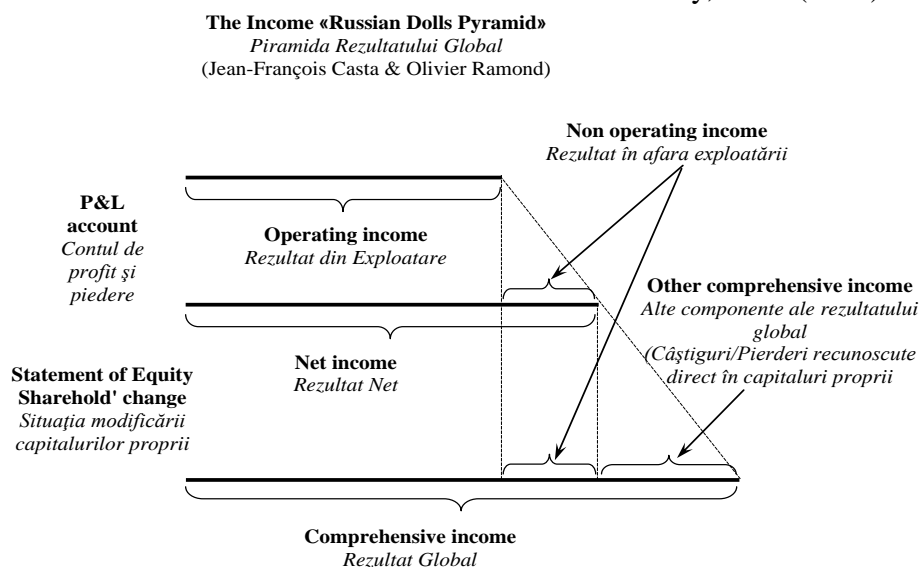


Figure no. 6. The comprehensive income versus the operating income

The presence of choices in accountancy raises the problem of the choice criterion of a certain accountancy policy. One can state that there is no objective income in the context of the international accountancy standards which can offer various possibilities for underlying the same transaction. Choosing an option over the other has a definite impact on the financial circumstances and on the accountancy result too. Beyond the impartial relationship of determining the income as a difference between the revenues and expenses carried, the freedom of choosing the accountancy policies causes either a reduction or an increase in the outcome in keeping with the goals undertaken by the management of the organization.

6. Modelling the comprehensive income

The comprehensive income represents a complex notion, closely related to notions such as: gains, capital, expenses, revenues, cash flow, a.s.o. Nowadays ,one can identify two great approaches of the income: the economic and the accounting one. According to the accounting approach, the comprehensive income of the organization is given by the difference between the incomes derived and the costs incurred for achieving the income. From the economic point of view, the result can be seen as a growth of the organization's well-offness within two periods of time. Fisher (1930) analyzed the individual income, being one of the first economists who made a difference between the concept of capital and the notion of gaining (benefit). The income (seen as benefit, gain) was defined by referring to the individual consumption and was not considered as a measure of the capital growth. Later-the year 1939 and later 1946- Hicks, in the work entitled *Value and capital* (former edition in 1939 and the latter in 1946), suggests a definition of the concept of income as being the maximum amount an individual can spend during a period of time, without

altering his financial position (Feleaga (Malciu); Feleaga 2005). According to Hicks' theory, transposed at the organizational level, the earnings of a commercial agent is what it can consume during a period of time without diminishing its well-offness and it can be calculated by means of the following pattern (figure no. 7) (Le Manh- Bena, 2009, p. 121):

$$Y_e = C + K_t - K_{t-1}$$

Y_e = income (the period earning)
 K_t = capital held at the end of the period t
 K_{t-1} = capital at the beginning of the period t

Figure no. 7. Hicks pattern for determining the earnings of an entity

Contrary to accounting, where the measurement of the result is accomplished after carrying out the economic events (ex-post), the economic gains, defined by Hicks matches a measurement based on the present value of future cash-flows, provided at that date, a thing hard to accomplish, because of the uncertainty in which an organization evolves. Therefore, the main limitations of Hicks 'pattern are caused by: the necessity of the strict foresight of the transactions that are to be carried out by the organization and the dependence of the result on individual expectations. Even if Hicks 'pattern cannot be applied to the organizational context, it represents a reference model for the theoretical models in determining the income of the organization further developed. In this respect, the benefit definition given by Hicks suggests that, this one can be determined by the deduction of the net income (total assets minus debts) from the beginning of the exercise , form the net assets, at the end of the exercise, the difference going to be adjusted later with the capital injections and withdrawals carried out within the period (Feleaga (Malciu); Feleaga, 2005). This approach of the beneficiary represents the start of the current balance sheet method, underlying the international accounting reference.

After the first attempts of shaping ,initiated by Fisher and Hicks, the theorists in the field developed sustainable patterns of determining the income of an organization. These ones appeared mainly in the second half of the XX century.

The transposition of the pattern of the defined income by Hicks at the organization triggered later the concept of accounting income initiated by Edwards and Bell (1961, pages 24-25). By means of an on-balance sheet approach, they give the following definition to the accounting income: *in the absence of dividend payments and of new shareholders contributions, the income is measured at the end of the period by summing up the updated values of all net receipts the managers look forward to earning from the net assets, from which the value at the beginning of the period shall be deducted.*

Solomons – professor at the University of Pennsylvania – starting from Hicks achievements proposes to differentiate the outcome into an economic and accounting one. (Solomons, 1961, pp. 374-384). The economic outcome is defined as a growth in wealth that comes out in a period without taking into account the shareholders' capital contributions or withdrawals. Solomons proposed a pattern of reconciliation between the accounting outcome and the economical one (Le Manh-Bena, 2009, pp. 123-124), shown in the figure no. 8. The model boundary is related to the establishment of the variations of value, unaccomplished during the period especially regarding the goodwill.

<p>Accounting outcome</p> <p>+ Changes in the value of the tangible and intangible assets unaccomplished during the period (latent earnings)</p> <p>- Value variations of tangible and intangible assets (including the goodwill) accomplished during the period, but incurred during an earlier period (losses or gains actually achieved)</p> <p>Economic income</p>

Figure no. 8. Solomons pattern of reconciliation between the accounting income and the economic one

Debates over the accounting income, initiated by Hicks pattern will keep on coming out. FASB gave a significant importance to an organization better-offness, suggesting to determine the income of an organization in close relationship to it. The proposition met the opposition from most accounting professionals who considered it a real threat to the basic principles of the commitment accounts. The result of this opposition was giving up the introduction of the concept of better-offness within a conceptual framework. The main objective of the financial statements is that of providing information regarding the performance of the organization, obtained by measuring the income and its components. According to Hicks pattern, the income at the organizational level is established by referring to the method of preserving its assets, also called the method of the net asset variation. This approach is being currently taken over by all the conceptual framework of FASB and IASB. Quoting Menard and Chlala, Feleaga present a calculus model of the income by using the method of preserving the assets (figure no. 9) (Feleaga (Malciu); Feleaga, 2005):

<p>Net asset at the end of the exercise</p> <p>- Net asset at the beginning of exercise</p> <p>The variation of the net asset</p> <p>+ Dividends reported during the exercise - The owners contributions during the exercise</p> <p>The net benefit of the exercise</p>

Figure no. 9. Calculation pattern based on the method of preserving the assets

This pattern has as limitation the lack of the necessary information regarding the structure and the size of expenses and incomes. The correct identification of the income is conditioned by the correct selection of the evaluation method.

The Alexander pattern- the pattern of variable income

To eliminate the effects of the unexpected losses or earnings, Alexander (1977), defines the concept of the variable income. The pattern is introduced by the relationship:

$$\text{Economic Income} = \text{Variabil Income} + \text{Unexpected Earnings/losses}$$

The variable income matches the revenue received during the financial exercise to which is added the capital growth expected from the very beginning of the period. The Alexander method could be successfully used for the real estates. Using it at the context of organization was meant to be a complex one, as it is difficult to state whether the expected growth of the capital reflected by the growth of the value of the asset represents a consequence of a good management of the organization or whether it is due to favorable events, being considered a chance circumstance.

The pattern of the comprehensive income based on a substitution cost

Summarizing the two approaches of the income, the financial and accounting, Edward and Bell (1961) present a pattern which should take into account the establishment of the accounting income theoretically and practically as well. They introduce the concept of economic income which they consider inadequate to the accounting practice. Their pattern represents a tool intended to the management of the organization and has as purpose for assuring a better support in decision making. The application of the traditional principles of the accounting: of prudence and historical cost are considered as being the factors that distort the income of the organization. According to the prudence principle, only the operations actually carried out are accounted. An assessment on the basis of the principle of the historical price, of the non-monetary assets whose value grow over time, can cause the existence of some holding gains which are not accounted for- the assets are registered at a lower cost. Thus, it becomes necessary the substitution of the historical income. The pattern suggested introduces a new concept, that of the replacement cost, which is used as a new basis in evaluating the assets.

The replacement cost represents what an organization should spend in order to purchase an identic good or the equivalent to the good under consideration (Feleaga (Malciu); Feleaga, 2005). This new concept represents the basis of the comprehensive income pattern. In this new approach, the income (figure no.10) is split into: current operating income, gains/ losses achieved as a result of holding gains or losses, and latent gains/ losses during the period.

The comprehensive income = ROC + PVR + PVL

ROC = current operating income evaluated on the basis of the substitution cost
PVR = capital gains carried out; gains/losses carried out during the period as a result of holding gains
PVL = latent capital gains; latent gains/losses during the period

Figure no. 10. The pattern of the comprehensive income, according to Edwards and Bell

Source: adapted from Le Manh- Bena, 2009, p. 129

Edwards and Bell's pattern regarding theorizing the accounting income approaches two essential elements:

- using the replacement cost as an assessment basis
- the distinction between the operating income and other gains or losses

The current operating income represents the period revenues from which are decreased the replacement cost of the assets, goods and services consumed for obtaining the gains. The gains and losses carried out represent the added values achieved precisely during the period to which the latent values are added, resulting from the variation of the replacement costs of the resources used. As a measure of reconciling the assessed income in historical cost with the assessed income in replacement cost, Edward and Bell suggest an alternative for their pattern, pattern that was shown in figure no. 11.

The comprehensive income = RCI + PVL – PVR n-1

RCI = contabil results in historical gains
PVL = latent capital gains; latent gains/losses during the period
PVRn-1 = value pluses or minuses carried out during the present period, but which came out during the previous periods
(previously recognized in the income)

Figure no. 11. Alternative to pattern of the comprehensive income, according to Edwards and Bell)

Source: adapted from Le Manh- Bena, 2009, p. 130

The two American theoreticians, Edwards and Bell took an interest especially in the measurement of the accounting income, in order to make the same assessment acceptable to all users. They seek to apply the accounting rules by using the current values departing from the economic notions of profit and better- offness, which they integrate into the accounting context (Feleaga (Malciu); Feleaga, 2005).

The pattern of the comprehensive income based on the exit price

Anne Le Mahn- Bena (2009, pages 132- 137) introduces the pattern suggested by Chambers which uses the exit price as an assessment basis. Chambers replaces the exit cost as assessment basis with the exit price. This new assessment basis represents the forerunner of the assessment at the fair value applied by the actual international accounting standards. The pattern suggested by Chambers (figure **no. 12**), is based on the achievable income which represents the measure of a change in the capital of an organization over a certain period evaluated on the basis of the sales value.

The comprehensive income = RR + PVL

RP = Achievable income, the income of the period from which the income corresponding costs are decreased (the assessment id made on the basis of the output value)
PVL = = latent added values; latent gains/losses during the period as a result of holding the assets evaluated in output values

Figure no.12- The pattern of the comprehensive income, according to Chambers

Source: adapted from Le Manh- Bena, 2009, p. 137

The assessment in exit prices provides a fair appreciation of the opportunity cost. The sales value of an asset represents the economical sacrifice carried by the organization in respect with the decision to retain the asset. The exit prices hold an objective nature in comparison with the cost of replacement which is a subjective one, being established by the organization.

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