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RELEVANCE OF DIFFERENTIATION OF REALIZED AND UNREALIZED PROFIT IN STRATEGIC MANAGEMENT

Abstract: The profit is an important factor in decision making by which strategic goals in company can be achieved. Prior to planning and deciding about the profit distribution is necessary to define the concept and method of determining profit. In legislation and professional literature from different areas of economic discipline, profit is perceived from different point of view and there are different approaches to determining it. For the measurement and assessment of financial performance is used profit and indicators calculated on its basis. Considering strategic goals, it is useful to pay attention not only to sum of profit, but also to part that will be distributed among the shareholders. Amount of the profit that is not distributed is source of financing and allows continuation of business. Strategic planning and subsequent investment of profit should be based on realized profit. The aim of the paper is to propose a method of determining realized profit. The identification of the items that makes up realized profits represent a stabile base for decision making. Quantified unrealized part of profit reflects the risks regarding business activities. Distribution of only realized part of profit will ensure the company sustainable existence in the context of strategic management.
Keywords: Unrealized profit, realized profit, strategic management.

1. INTRODUCTION

Strategic management includes activities, which's aim is to provide resources to meet the entity's strategy. A business strategy can be focused on the growth and development of an entity, transition to diversification, stabilization, growth, downturn or revitalization of the entity. In this, maintenance of assets and capital is very important (Markovič, Grančičová, & Juhászová, 2013; Tumpach, & Baštincová, 2014). The goal of any business is to make profit. (Lovciová, 2018) The strategy identifies long-term goals including profit goal, procedures for the implementation of activities and the allocation of resource to enable the entity to achieve its objectives. The financial situation also significantly affects the other functional areas of strategic management, whose growth and development requires financially demanding investments. This implies that the financial strategy penetrates the whole accounting unit and has a cross-sectional character. Necessary condition for proper financial management of the entity are reliable information from the external and internal environment of the entity. Internal information is provided by a business information system including accounting, calculations, records, reporting and statistics. Internal business information system should provide an objective and ready picture of the whole business activity. For the needs of financial management is important mainly the overview of the movement of capital, money, receivables and payables in real time. (Slávik, 2009) Profit as the main indicator of an entity's financial performance is a key instrument of financial management. The amount of profit is in the focus of interest not only of management, but also of investors and shareholders, since from this amount is derived the amount of dividend. At present, regulation of accounting and presentation in financial statements allows and, in some cases, requires the disclosure of unrealized gains and thus increased profit presents the entity in a better financial situation than it is. Use of unrealized part of profit, for example for distribution to shareholders, worsen the financial situation, because unrealized income does not contribute to increase cash, but dividends pay out causes its outflow. Distribution of the entire profit, including the unrealized part, increases the indebtedness of the entity, thereby it can endanger financial stability and sustainability over the long term.

2. AIMS AND METHODS

The aim of this paper is proposing method for determining realized profit and separating an unrealized portion of profit that should not be distributed to shareholders. The subject of paper is highly relevant as profit or loss is and indicator of the entity's development, derives the entity's profitability and viability and determines the entity's financial strategy. The basis of the problem processing of the realized and unrealized profit is legislation at national and international level, domestic and foreign publications relating to investigated issue. In this paper we used the selection method to separate useful information from less important information. Using the comparative analysis method, we compared national and international legislation in the field of accounting and reporting of income, expenses, profit and loss. Findings were summarized in the conclusion using synthesis.

3. RESULTS

Information about financial situation, financial performance and changes in the financial situation that form the basis of the various decisions regarding strategic management are included in financial statements. The quality of the financial statements depends on the reliability and economic substance of the financial statement. Financial statements for the accounting period are an important source of information for financial analysis. Adequate use of data allows analysis of history, anticipate the future and the relating planning of entity's activities. (Kubaščíková, & Pakšiová, 2015) In the area of accounting and financial reporting is regulation in Slovak Republic defined in detailed way by law and other regulation at a lower level. (Parajka, 2016) Accounting and financial statements at national level in the Slovak Republic are primarily regulated by Act No. 431/2002 on Accounting, as in effect (hereinafter the "Act on Accounting") and lower legal standards in the form of Measures of the Ministry of Finance of the Slovak Republic, which are as follows:

- Measure of the Ministry of Finance of the Slovak Republic of 16 December 2002 No. 23054/2002-92, On stipulation of details of accounting procedures and framework chart of accounts for entrepreneurs keeping double-entry accounting in the wording of Measure of the Ministry of Finance of the Slovak Republic of 11 December 2003 No. 25167/2003-92 and Measure of the Ministry of Finance of the Slovak Republic of 24 November 2004 No. MF/10069/2004-74 (hereinafter the "Accounting practices"),
- Measure of the Ministry of Finance of the Slovak Republic No. MF/15464/2013-74 defining details of the arrangement, marking, and content specification of items of an individual financial statement and extent of data determined for publication from an individual financial statement for entrepreneurs using double entry bookkeeping for micro accounting units (hereinafter the "Measure of MF SR No. MF/15464/2013-74"),
- Measure of the Ministry of Finance of the Slovak Republic from 3. December 2014 No. MF/23378/2014-74 defining details of the arrangement, marking, and content specification of items of an individual financial statement and extent of data determined for publication from an individual financial statement for entrepreneurs using double entry bookkeeping for small accounting units (hereinafter the "Measure of MF SR No. MF/23378/2014-74),
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At the international level of the European Union, the financial statements are regulated by directives and regulations:

- Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repeating council Directives 78/660/EEC and 83/449/EEC (hereinafter "Directive 2013/34 EU of the EP and of the Council"),
- Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council.

By Commission Regulation No 1606/2002 of the European Parliament and of the Council has been adopted International Financial Reporting Standards (IFRS), which includes:

- International Financial Reporting Standards (IFRS),
- International Accounting Standards (IAS),

- Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) from year 2002 and till 2002 the former Standing Interpretations Committee (SIC). (IAS 1 Presentation of Financial Statements [IAS 1], 2018)

Act on Accounting (2018 Art. 17, par. 1) defines financial statements as follows: "Financial statements are a structured representation of the facts, representing the subject to accounting, to persons who use this information". According to IFRS financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. (IAS 1, 2018) Comparison of components of financial statements according to Act on accounting and IFRS are shown in table 1.

Table 1: Comparison of components of financial statements according to Act on accounting and IFRS

Components of financial statements according to Act on accounting	Components of financial statements according to IFRS
The balance sheet shows information on the assets and liabilities of the accounting entity and the difference between them, to a date to which the financial statements are prepared and to the date to which the financial statements are prepared for the immediately preceding accounting period	Statement of financial position as at the end of the period
	Statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements
The profit and loss statement present expenses, revenues and profit or loss for the accounting period and for the immediately preceding accounting period	Statement of profit or loss and other comprehensive income for the period
The notes contain information explaining and supplementing the information contained in the balance sheet and the profit or loss statement and/or other explanatory and supplementary statements and information	Notes, comprising significant accounting policies and other explanatory information (comparative information in respect of the preceding period)
	Statement of changes in equity for the period
	Statement of cash flows for the period

Source: own processing
according to Act on accounting and IFRS

According to the Measures of the Ministry of Finance of Slovak Republic, which regulate the preparation of financial statements for large entities, an overview of changes in equity and cash flow statement is included in notes. (Measure of MF SR No. MF/23377/2014-74) Micro entities preparing simplified financial statements and small entities are not obliged to prepare an overview of changes in equity and cash flow statement. (Measure of MF SR No. MF/15464/2013-74, Measure of MF SR No. MF/23378/2014-74)

In regulation and professional publications from different areas of economic disciplines, profit is perceived from different point of view, due to there are different approaches to determining it. In the following section, we will point out different approaches of profit definition, especially from the point of view of regulation related to accounting and financial reporting. In Slovak Republic Act on Accounting (2018) does not define the term profit but denotes it as economic result that may have the character of profit or loss. Determination of economic result content can be found in Accounting practices (2004), whereby the economic result can be profit or loss. Economic result is an evaluated resulting effect of the entity's activity achieved in the accounting period. (Act on Accounting 2018) Act No. 595/2003 Coll. Income Tax Act, as in effect (hereinafter „Income Tax Act ") for determining the tax base refers to the Act on Accounting, namely to the concept of profit or loss. The corporate income tax base in entity that does double-entry bookkeeping is determined from the economic result, so from the profit or loss. The Income Tax Act (2018) uses term of profit mainly in the field of dividend (profit-sharing) but does not define it. Act No. 513/1991 Commercial Code, as in effect (hereinafter „Commercial Code") uses the term of net profit, which is first mentioned in second part of the act in clause about reserve in Article 67, according to which net profit is profit of the current accounting period reported in approved general purpose financial statements. At European Union level, Directive 2013/34 EU of the EP and of the Council does not define profit or loss. Profit is only determined with regard to the prudent principle: only profits made at the balance sheet date may be recognised. (Directive 2013/34 EU of the EP and of the Council, 2013) IFRS in Conceptual Framework (2010) refers the profit as a measure of financial performance or basis for further measurement (for example return on investment, earnings per share). For the definition of profit or loss see IAS 1 (2018) as follows: "profit or loss is the total of income less expenses, excluding the components of other comprehensive income". (Art. M5) Accounting is always the starting point for determining the financial result, regardless of whether it is a profit or loss. (Pakšiová, 2017) If in the accounting period, for which the profit or loss is determined, the income is higher than the expenses, then the economic result is profit. Otherwise, the economic result is a loss, when incomes are lower than expenses in accounting period. In the Slovak Republic all incomes and expenses are presented in profit or loss statement in the breakdown according to operational or financial activity. (Accounting practices, 2014; Košovská, Váryová, Krajčírová, Ferenczi Vaňová, & Bojňanský, 2017; Pakšiová, 2014; Šlosárová, 2014)

IFRS offers two income and expense presentation options. One option is to present expenses and income through two statements: statement of profit or loss and separate statement of total other comprehensive income. In this case in statement of total other comprehensive income are not included part presenting income and expenses, because they are content of statement of profit or loss. An entity may present one statement of comprehensive income for the period, which is divided to two parts: statement of profit or loss and other comprehensive income. In first part are presented income and expenses and in second part other comprehensive income. In part other comprehensive income are presented income and expenses that are not recognised in profit or loss, which includes items as changes in revaluation surplus, gains and losses arising from translating the financial statement of a foreign operation, remeasurements of defined benefit plans and other gains and losses arising from remeasurement of financial instruments. (IAS 1, 2018) Presentation of expenses and income according to IFRS is significantly different from reporting in Slovak Republic due to other comprehensive income that compromises among income and expenses gains and losses. Gains and losses do not have equivalent in national legislation. Definition of income according to Act on Accounting (2018) is "an increase in an accounting entity's economic benefits during an accounting period which may be reliably valued". (Art. 2, par. 4 c) Expense are defined as follows: „a decrease in an accounting entity's economic benefits during an accounting period which may be reliably value“. (Act on Accounting, 2018, Art. 2, par. 4 e) To definition of income and expenses is needed to add a definition of „economic benefits, which means the possibility of directly or indirectly contributing to cash flows and cash equivalents“. (Act on Accounting, 2018, Art. 2, par. 4 d) Conceptual Framework (2010) defines not only income and expense but also gains and losses. Income represents both revenue, which arises in the course of the ordinary activities of an entity, and gains, which may or may not arise in the course of the ordinary activities. Revenue from the ordinary activities is for example revenue from sales of products or stock, revenue from sales of services, interest, dividends. Gains arising for example, from disposal of non-current assets, revaluation of marketable securities. "Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity other than those relating to distributions to equity participants." (Conceptual Framework, 2010, par. 4.25 b) Expenses can be divided to expenses from ordinary activities and to losses. Expenses that arise from the ordinary activities of the entity include cost of goods sold, wages, depreciation. Losses may or may not arise from ordinary activity, they include for example losses resulting from disaster such as flood and fire, from disposal of non-current assets, from changes in exchange rate of foreign currency. (Conceptual Framework, 2010)

Economic result is determined based on realized and unrealized income and expenses. Distribution of realized and unrealized profit between shareholders is highly current topic of the present, due to assessment of impact of such transactions on the entity's financial position. Distribution of dividends decrease the value of entity and transfers assets from borrowers to shareholders, which means a higher risk for shareholders. (Chen, Gavious, & Steinberg, 2017) Dividend payments represent decrease in equity and at the same time decrease in cash, occasionally increase of debt, from which are dividend payments covered. Unrealized income contributes to cash flow only if they become realized, but till realization their distribution results only cash outflows. (Gandhi, 2016) Distribution of unrealized profit entails significant risks and therefore it is crucial to distinguish between realized and unrealized expenses and income. In identifying realized and unrealized items of income and expenses is necessary to take into account the prudence principle. Prudence principle should be used in assessing uncertain facts in a way that the entity should not present itself richer than actually is. Application of prudence principle ensures that in financial statements are recognised only income that have been realized as of balance sheet day. Also, in the area of expenses it is necessary to take in to account all anticipated risks and estimated expenses. (Šlosárová, Kadlečíková, Kovalčíková, & Máziková, 2016) Prudence is applied based on four principles on lower level: impartial, realization, lower pricing and value lightening principle. Application of the impartial principle requires an entity not to account and present in financial statements unrealized income. On the other hand, unrealized expenses are required to be accounted for and present in the financial statements. This principle in the field of revaluation of assets and liabilities in foreign currency at the balance sheet day is violated in the Slovak Republic. Since exchange gains from revaluation of assets and liabilities in foreign currency as of balance sheet day are accounted and reported. The realization principle is applied if the potential sales price of the assets is higher than the value in accounting evidence, but income and profit can be recognized only after the sale of the assets under the condition of realization. To reach prudence should be applied a lower price principle, which requires items of assets present in lower price expressed through accumulated depreciation or amortisation and impairment provision. An example of applying the principle of lower price is when the valuation of inventories at purchase price or cost is higher than fair value or net realizable value of a particular type of inventory. (Šlosárová et al., 2016) The principle of value lightening principle consists of the fact that between balance sheet day and day of the financial statements construction entity may obtain information that is useful to the users to assess the entity's financial position and therefore the entity discloses that information in notes. The entity does not account for these information, because they do not meet the recognition criteria. (Kršeková, 2016) Directive 2013/34 EU of the EP and of the Council (2013) refers to prudence principle in article 6 General financial reporting principles as follows: "recognition and measurement shall be on a prudent basis, and in particular:

- only profits made at the balance sheet date may be recognised,

- all liabilities arising in the course of the financial year concerned or in the course of a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up, and
- all negative value adjustments shall be recognised, whether the result of the financial year is a profit or a loss". (par. 1 c)

However, prudence principle, one of the oldest and the most well-known accounting concept, was eliminated from Conceptual Framework in 2010 still requires attention. (Măciucă, Hlaciuc, & Ursache, 2015) Prudence principle was eliminated from Conceptual Framework, because it was not considered to consistent with neutrality according to the view of some respondents. Creators of Conceptual Framework provided space for further discussion on the prudence principle, so that its meaning could be clarified and the differences in its interpretation eliminated. Exposure Draft from 2015 proposes to re-introduce prudence principle and deals with creation of new definition, which is consistent with neutrality (Cooper, 2015) In May 2016 the Board decided to confirm tentatively that Conceptual Framework should contain reference to prudence. Prudence should be applied when assessing under conditions of uncertainty as it is proposed in Exposure Draft. In Exposure Draft is stated that neutrality is supported by the applying prudence. Exercise of prudence means, that assets, liabilities, income and expenses are not understated and not overstated. Exercise of prudence according to Exposure Draft is divided to exercise of cautious prudence and asymmetric prudence. Asymmetric prudence relating to recognition of losses and gains will be discussed at a future Board meeting. (Summary of tentative decisions, 2017) Prudence principle can be exercised to avoid understatement of assets and income or overstatement of expenses and liabilities, which results not a true and fair view of presentation in financial statements.

In the following parts of paper, we will not pay attention to unrealized expenses, because we consider that prudence principle in entities is applied in way that financial statements present true and fair view. Under the terms of recognition of income in Slovak Republic for unrealized income we consider the followings:

- the positive balance of work in progress and finished goods,
- exchange rate gains on the translation of assets and liabilities in foreign currency at the balance sheet day,
- gains from revaluation to fair value at the balance sheet day.

The positive balance of work in progress and finished goods going to be recognised as income in moment when goods are sold (realized) outside the entity and income will be recognized as revenues from sales. Till the moment of realization is income from work in progress and finished goods recognized less of write downs, which estimate the temporary impairment, or the risk associated with the sale in the future. In accordance with the Act on accounting (2018), assets and liabilities in foreign currency are translated at the balance sheet day by exchange reference rate. Provided and received advance payments in foreign currency are not translated as the date of financial statements. Exchange rate gains arising from the translation of assets (mainly receivables and cash) and liabilities in foreign currency as of balance sheet day we identified as unrealized gains, because in moment of realization of asset or liability in future there may also occur a loss from currency translation. Unrealized income include also gains on revaluation of assets held in entity, which is revaluated to the fair value as of the balance sheet day with impact on profit or loss. Assets, which are revaluated to the fair value through profit or loss includes securities held for trading, commodities or other assets, that was not produced by the entity only acquired for the purpose of resale in the public market.

From the view of IFRS determination of items that fall under the category of unrealized income and expenses is a complex problem as the IFRS financial statements do not have united structure. Other comprehensive income includes income and expenses, which are not presented in profit or loss statement, but their presentation is required or allowed by other standards. Total comprehensive income is defined as a change in equity during the accounting period that results from transactions and events other than changes resulting from transactions with owners. It is not right to claim that only realized income and expenses are included in the profit or loss statement and only unrealized income and expenses are the content of other comprehensive income. For example, gains from property revaluation in accordance with IAS 16 Property, plant and equipment are recognized in other comprehensive income. On the other hand, property revaluation gains under IAS 40 Investment Property are recognized in the statement of profit or loss. Both gains are unrealized. A similar case may also occur when revaluating financial instruments at fair value when they can be recognized either in profit or loss statement or in the other comprehensive income in accordance with the entity's decision. In order to assess unrealized and realized income in the IFRS financial statements an individual approach is required. The IASB discusses the status of other comprehensive income and sets three approaches to solve inconsistencies regarding the reclassification of the items in the profit or loss statement, but no decisions have yet been made about the alternative that should be applied in the professional practice. (ACCA, 2018)

Distribution of profit is in full competence of the entity's decision-makers as IFRS does not contain any limitations on profits distribution and at national level the Commercial Code and the Act on Accounting regulate only partially this issue. The Commercial Code (2018) regulates the creation of reserves so that, the reserve fund needs to be contributed from net profit, if the law does not establish the obligation to create reserve fund, when the company is formed. Limited liability company and joint stock company contribute to the reserve fund from net profit, which can be distributed only after the reduction in amount of contribution to reserve fund. (Commercial Code, 2018) Limited liability company, which did not create a reserve fund at its formation, contributes to the reserve fund at least 5 % of net profit until the reserve fund reaches at least 10 % of the registered capital. (Commercial Code, 2018) In the case of a joint stock company an entity at its formation creates reserve fund in amount at least 10 % of registered capital. In followings is required to contribute every year at least 10 % of net profit minimally to amount of 20 % of registered capital. (Commercial Code, 2018) For joint stock companies is valid that the entity "shall not be allowed to distribute among the shareholders net profits or other funds of the company in case the equity appearing in the approved ordinary financial statements is, or as a result of the distribution would be lower than the registered capital plus the reserve funds, which the company can't use to make payments to shareholders under the law or according to the articles of association of the company". (Commercial Code, 2018, art. 179, par. 4) Act on Accounting (2018) regulates profit distribution relating to activated cost of development: "if the activated costs of development have not been amortised in full, the accounting unit can distribute the profit provided that the aggregate amount of reserve funds and other equity components available for pay-out is higher than the total amount of the not amortised activated costs of development. (Act Accounting, 2018) The Commercial code and Act on Accounting regulates obligation not to distribute the profit, but the degree of restriction is very low. Distribution of profit based on realized and unrealized profit is subject to several investigations at the international level. Chen, Gavious, & Steinberg (2017) investigated if entities distribute profit not only from realized or from unrealized profit either. Furthermore, they examined the effect of the distribution of unrealized profit to the entity's risk and the cost of debt, or possibly restructuring. They found out that the distribution of unrealized profit causes a shortage of resource in the entity and represents a higher probability of predictable failure, which is in line with the hypothesis of reallocation of wealth. (Chen, Gavious, & Steinberg, 2017) Sikalidis & Leventis (2017) have also reached similar conclusions in their research, according to which the distribution of unrealized profit, for example, from revaluation of investment property and securities, is causing concern among regulators and market participants, because higher dividends are likely to increase indebtedness and risk, which potentially contribute to the procyclicality of the financial system. They also concluded that the revaluation of the fair value of investment property in accordance with IFRS is persistent (it is reliably predictable future income), but adjustments to financial instruments, especially securities, are temporary. Gains from revaluation of investment property are in practice distributed to shareholders through dividends, in contrast to income from securities revaluation. This suggests that managers are aware of the persistence of income components adequately. (Sikalidis & Leventis, 2017)

4. CONCLUSIONS

The issue of determining the realized and unrealized profit and its subsequent distribution among shareholders is an actual topic currently. Especially in the context of strategic management that needs timely and reliable information to make various decisions. Identification of the unrealized and realized portion of the profit is necessary to make in accordance with the legislation, under which the financial statements were prepared. Slovak legislation requires the financial statement to be presented in a uniform template, allowing for a more general approach to distinguishing realized and unrealized profit. However, in the case of IFRS financial statements an individual approach is required. Distribution of unrealized and realized profit is exercised in practice and increases the entity's debt, as causes cash outflows. It happens in practice, that the entity finances dividend payments from loans and other outside sources. Higher indebtedness represents the risk of the sustainable existence of the entity in the context of the strategic management. Legislation regulates the profit distribution in joint stock companies and limited liability companies, but only at limited extent. Establishing a minimum reserve fund obligation to require a shareholder to surrender at least 5% or 10% of the net profit. The Commercial Code has been supplemented by the regulation that an entity can't distribute among shareholders net profit or other entity's own resources if it causes its bankruptcy. We can explain this as an effort to limit the distribution of unrealized profit. Ultimately, the decision on the distribution of realized and unrealized profit remains within the competence of shareholders and managers, who should reach agreement to the issue of profit distribution so that the existence and financial stability of the entity is not jeopardised.

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