

PROFESSIONAL JUDGMENT UNDER IFRS IN EX-COMMUNIST COUNTRIES: CASE OF ROMANIA

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The accounting rules from each country evolve in time in order to respond the social, cultural and economical environment needs. After some communist countries (as Romania, Bulgaria, Poland, Hungary, Czech Republic, Slovenia, Estonia, Lithuania, s.o.) joined the European Union an important number of local companies became to apply accounting regulation according with International Financial Reporting Standards (IFRS).

This paper surveys the theoretical and empirical literature on the possible risks for companies' management from ex-communist countries by applying (mandatory or voluntary) International Financial Reporting Standards reporting regulation and professional judgment.

Under the pressure of economic globalization all the ex-communist countries were obliged to adopt International Financial Reporting Standards in the field of accounting. The main objective of this paper is to find out from the experience of different companies who already adopted IFRS which are the risks related to professional judgment application under IFRS on the financial statement users.

As research methodology we integrated theoretical and empirical studies from accounting and law (especially from Romanian experience) in order to contribute to the cross-fertilization of our field of interest.

As final results of our paper we find that the biggest risk of applying professional judgment prescribed by IFRS in ex-communist countries is to appear different creative accounting techniques which influence in a negative way the decision-making process for the financial statements users. During worldwide financial crisis the majority of Romanian companies tried to use in the most appropriate way the professional judgment in order to arrange their financial reports and to save company's money (in relation with local government) or to show higher performance (in relation with financial institutions) for the fund-raising process

We identified several motivations including the existence of tax levies based on income, confidence by shareholders and workers in management that is able to report stable earnings and psychological expectations relating to increases or decreases in anticipated income.

Keywords: professional judgment, IFRS, globalization, creative accounting, risk

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Introduction

For several decades we observe that in many key industries companies from ex-communist countries as Romania, Bulgaria, Hungary, Czech Republic or Poland increasingly are confronted with worldwide competition. They have responded to this challenge with strategies of globalization. As a result, not only the leading companies now operate on a global basis with subsidiaries in all important regions even in central and south-east European countries. The pressure to globalize is also felt by many focused small and medium sized enterprises that are suppliers of components or specialized services to the giant multinational companies. Globalization, which characterizes the economic world, led to the necessity of understanding and comparison of the financial information of different corporations and also to present the fair view of businesses.

After some communist countries joined the European Union an important number of local companies became to apply accounting regulation according with International Financial Reporting Standards (IFRS). Ex-communist countries accounting developed remarkably in the last fifteen years, as shown by the flow of accounting literature in this field at national and international level. This development is mainly the result of preparations for EU accession by increased needs for attracting foreign investments, of achieving international comparative analyses, of expressing rules for determining results, of providing minimal accounting information to players on European and international capital markets, as well as of harmonizing and subsequently converging national, European and global accounting standards. In this way the accounting rules from each ex-communist country evolve in time in order to respond the social, cultural and economical environment needs (Ineovan, Hategan, Megan and Schmidt 2001: 8).

Globalization strategies are not restricted to operating and investing activities but increasingly also involve financing. Foreign listings (excepting companies from ex-communist countries) are not new to US multinationals or many of the large European companies being traded at home as well as on other major European and Asian stock exchanges (such as London, Frankfurt, Paris, Tokyo). New in recent years is that an increasing number of European companies are applying for listing on US stock exchanges notwithstanding the fact that complying with Securities and Exchange Commission (SEC) requirements puts quite a burden on them.

Accounting information plays a crucial role in those processes. For globalizing companies accounting reports are a vital means of internal communication between managers and employees from different national backgrounds. The correct application of accounting policies regarding the subsidies is required mainly by the existence of a manual of accounting procedures and policies within each entity (Hategan, Imbrescu, Pavel 2010: 344). Even though the core concepts of accounting are not very different internationally, we observe differences in rules and differences in the application of those rules that hamper internal communication. This problem traditionally was overcome by internal accounting guidelines that were mainly based on the national accounting rules of the parent companies. In view of adhering to the European Union, many east-European ex-communist countries understood the necessity to line-up with accounting standards in the Union and increased its efforts for adapting to these requirements. A great weight in the decision for reforming the east-European accounting national systems in that past period was represented by the necessity to take certain measures for helping these countries and its economies to develop and integrate themselves among the E.U. countries. Thus, at national level it has been perceived that the accounting harmonization process: will create the premises for attracting direct foreign investments, will reduce costs for these companies looking for financing on international capital markets for preparation of accounting information, will create a benefic frame for development of capital market in our country, will reduce commercial barriers and those related to international monetary cash-flows.

Risks of using professional judgment in ex-communist countries

Various researchers have examined the professional judgment and the issue of management motivation towards creative accounting behavior for East-European companies. We identified several motivations including the existence of tax levies based on income, confidence by shareholders and workers in management that is able to report stable earnings and psychological expectations relating to increases or decreases in anticipated income.

Tax is mentioned as a significant motivator also by many authors (Niskanen and Keloharju 2000: 443-452). In countries with highly conservative accounting systems as ex-communist countries the 'income smoothing' effect was particularly pronounced because of the high level of provisions that accumulate. Another bias that sometimes arises is called 'big bath' accounting, where a

company making a bad loss seeks to maximize the reported loss in that year so that future years will appear better.

Healy examines managers' earnings manipulations motives where executive compensation is linked to income measurement. Other authors discuss about managers' motivations to reduce the perception of variability in underlying economic earnings of the firm (Trueman and Titman 1988:127-139).

Kamin and Ronen observe a difference in motivation between managers in owner-controlled and management-controlled firms. Owners who wish to retain control of a sizeable stake and who are therefore not interested in immediate exit strategies are less likely to be motivated to manage earnings.

Other motivations for creative accounting discussed by some authors include those provided when significant capital market transactions are anticipated, and when there is a gap between the actual performance of the firm and analysts' expectations. A variant on income smoothing is to manipulate profit to tie in to forecasts. Fox reports on how accounting policies in some companies from ex-communist countries are designed, within the normal accounting rules, to match reported earnings to profit forecasts. When these companies sell products a large part of the profit is deferred to future years to cover potential upgrade and customer support costs. This perfectly respectable, and highly conservative, accounting policy means that future earnings are easy to predict. Company directors may keep an income-boosting accounting policy change in hand to distract attention from unwelcome news. Collingwood reports on how a change in accounting method boosted a company's quarterly profit figure, by a happy coincidence distracting attention from the company slipping back from being the largest company in the industry in the USA to the number two slot.

Creative accounting may help maintain or boost the share price both by reducing the apparent levels of borrowing, so making the company appear subject to less risk, and by creating the appearance of a good profit trend. This helps the company to raise capital from new share issues, offer their own shares in takeover bids, and resist takeover by other companies. If the directors engage in insider dealing in their company's shares they can use creative accounting to delay the release of information for the market, thereby enhancing their opportunity to benefit from inside knowledge. It should be noted that, in an efficient market, analysts will not be fooled by cosmetic accounting charges. Indeed, the alert analyst will see income-boosting accounting changes as a possible indicator of weakness.

Another set of reasons for creative accounting, which applies to all companies, arises because companies are subject to various forms of contractual rights, obligations and constraints based on the amounts reported in the accounts.

To discover and confirm the hypothesis regarding the implications of creative accounting on ex-communist countries companies, at the beginning of the year 2010 we performed a survey in a ex-communist country (Romania) on a non-representative sociological sample of 70 Romanian companies, which applied accounting standards in compliance with IFRS.

Based on this survey we received answers from the heads of financial-accounting departments regarding a series of questions about Romania applying the IFRS.

The main questions regards the application of professional judgment in a creative way by Romanian companies. By these questions we tried to question financial controllers from Romanian companies about their experience in applying professional judgment in a creative way and they were able to conclude that a significant proportion of all categories of companies employ creative accounting techniques to some extent. We examined some particular aspect or technique of creative accounting. All tend towards the conclusion that creative accounting using that particular technique does exist. Based on our survey, we registered the following results:

Q1. Do you think the accounting regulations according IFRS allow you to apply creative accounting for tax purposes?

61,4% thinks that the new accounting regulations allow to apply creative accounting for tax purpose; 10,0% didn't recognize the creative accounting concept and 28,6% are irresolute regarding that subject.

Q2. Which are the main reasons for applying creative accounting?

38,6 % think that the main reason is taxation, 24,3 % think that the reason is access to bank funds, 22,9 % think that the main reason is the interest of managers, 8,6 % think that the main reason is the interest of stakeholders, 5,7 % think that the main reason is the better presentation for exchange market.

Q3. Which are the techniques of creative accounting?

The surveyors answers were: exploitation of professional judgment (40%), IFRS flexibility (25,7%), manipulation of balance sheet amounts (11,4%), artificial transactions (10%), lack of detailed accounting regulations (7,1%), reclassification of debts (5,7%). The potential for creative accounting in Romania and for sure also in other ex-communist countries is found in few principal areas: regulatory flexibility, a lack of regulation, exploitation of professional judgment, the timing of some transactions, the use of artificial transactions and finally the reclassification and presentation of financial numbers.

According Largay, Mulford and Comiskey even in a highly regulated accounting environment such as the E.U., a great deal of flexibility is available.

Romanian accounting practice accounting regulation often permits a choice of policy; for example, in respect of asset valuation (IFRS and EU Directives permit a choice between carrying non-current assets at either revalued amounts or depreciated historical cost). Business entities may, quite validly, change their accounting policies. But in practice such changes may be relatively easy to identify in the year of change, but are much less readily discernible thereafter.

Other areas are simply not fully regulated. For example, there are very few mandatory requirements in respect of accounting for stock options. In the majority of countries, accounting regulation in some areas is limited: for example the recognition and measurement of pension liabilities and certain aspects of accounting for financial instruments.

Other problem is the character discretionary and nondiscretionary elements of the bad debts provision. For that the accountants must apply professional judgment and the relativity may introduce some manipulations of result for the period.

On the other hand our research found a sort of managers acknowledged manipulative behaviors and short-term orientations for their mandate for companies where the managers are not stakeholders.

The company's' artificial transactions can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods. This is achieved by entering into two or more related transactions with an obliging third party, normally a bank. For example, supposing an arrangement is made to sell an asset to a bank then lease that asset back for the rest of its useful life. The sale price under such a 'sale and leaseback' can be pitched above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals.

Reclassification in balance sheet and presentation of financial numbers are relatively under-explored in the literature. The firms may engage in balance sheet manipulation to reclassify liabilities in order to smooth reported liquidity and leverage ratios. A special type of creative accounting relates to the presentation of financial numbers, based on cognitive reference points. As explained by Niskanen and Keloharju "the idea behind this behaviour is that humans may perceive a profit of, say, 301 million as abnormally larger than a profit of 298 million". Their

study has indicated that some minor massaging of figures does take place in order to reach significant reference points.

As we can see from our empirically research even though manager's motivation for creative accounting may be established and accepted in practice. Respected financial professionals, demonstrate that it's a lot harder to manipulate cash-flows, but the interest of management can be very strong in that manners to "make-up" other face for their company (Megan, Schmidt, Cotlet 2010: 512).

All of the creative accounting behaviors identified in this study was identified through careful analysis of the answers of financial controllers and of financial statements. Some of the manifestations were easier to identify than others, but all should be observable by a reasonably well informed user of the financial statements.

Conclusions

In Romanian accounting practice as in other ex-communist countries there are some unusual features of environment that merit special attention. The audit report qualifications are common, even in respect of major listed companies. The majority of qualifications in Romanian companies are oriented on fix assets valuation and to accrued expenses to avoid local taxes or decreases of profit for managers' bonus. In these conditions we ask: if the creative accounting behavior is so obvious, can it properly be classified as creative accounting at all? However, the extent to which users of the statements actually do observe such relatively clear examples of creative accounting is uncertain. It has been observed that analysts' reports in Romania usually fail to mention the existence of audit report qualifications, special authorizations from CNVM (National Securities Commission) or other manifestations of creative accounting practices.

Regardless of creative accounting techniques we can suggest some recommendations to combat creative accounting.

Romanian accounting regulators who wish to limit the opportunities in which creative accounting can be used could consider the possibility of approaching separately the diverse situations that allow the application of creative accounting:

The first step towards the reduction of possibilities to use creative accounting is to be made by the Romanian regulators (Finance Minister or National Securities Commission) and consists in the continuous development of a conceptual framework in the line of professional work. In this way, the objectives of financial information will be clarified and priorities clearly established. In these new conditions the orientations to design accounting rules have a double function, firstly they affect accounting standards-setters but they also establish general criteria which are useful to professionals in that they allow a more profound understanding of accounting legislation, which facilitates the analysis of complex cases and lays the foundations of a professional opinion about accounting practices.

The second step: in the field of election of an accounting method over another creative accounting could be reduced by reducing the allowed accounting criteria or clearly specifying the circumstance in which a method should be applied. It can also help to require uniformity in the use of accounting methods. Today, in Romania the accounting criteria can be changed if it is explained in the Annual accounts' report and the impact of this change is quantified in the result of the company. If the change of criteria is forbidden, when a company chooses criteria, because with it achieves the image that is needed for that financial year, the same criteria will have to be used in future circumstances.

The third step: limitation of financial managers potential abuse using their own opinion could be moderated by using two methods. The first method consists in designing accounting norms which minimize the use of subjective opinions. For example, accountants in the United Kingdom tended to use the extraordinary section in the profit and loss account to include accounts avoiding its

inclusion in the ordinary profit. The Accounting Standards Board (ASB) in the United Kingdom responded by abolishing the category of extraordinary accounts.

The second method is that auditors must intensify their role in the identification of bad estimations. When completing auditing reports, these professionals must evaluate if there have been accounting manipulations of the annual accounts. In this area, it is worth mentioning the existing debate around the responsibilities assigned to the auditing function. Audit expectations gap, is the concept used to describe the difference between what is expected from auditors and what is actually established in current legislation. We sustain the opinion that the auditing function should include the evaluation of internal control systems of the company to identify in a preventive manner the cases of creative accounting, or in extreme cases of fraud which can be extremely dangerous for company, for their financial statements users and for the society.

Many managers argue the artificial transactions by invoking the concept of "substance over form", by which is the economic substance and not the legal form of the transaction what determines the accounting substance.

As we have seen in accounting literature creative accounting is perceived as a characteristic of the Anglo-Saxon approach to accounting, very flexible and with scope for different opinions, much more than the continental European model, which traditionally is more rigid and with detailed accounting norms. In any case both approaches have potential for the reduction of the possibilities to control creative accounting. The continental European model facilitates the reduction of the possibilities to abuse the election of an accounting policy and the manipulation of accounting estimates. The Anglo-Saxon model drives towards the use of 'substance over form' and revaluations.

By applying IFRS and EU Directives the Romanian accounting is in the last years much more closer to Anglo-Saxon approach and the risks of bad presentation of financial information by financial statements is higher and the difference between financial accounting and tax accounting become to be deep.

For this reasons Romanian accountants have to accustom with ethical behavior and CECCAR (The Body of Expert and Licensed Accountants of Romania) make big efforts to develop this concept in our profession. On the other hands the Romanian regulator have to anticipate and action to reduce the techniques of creative accounting. In the last years with the assistance of professional auditors Romanian accounting tend to become more correct and true fair-view oriented. Without this features Romania will lose at the level of credibility with direct effects on foreign invests or country image.

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