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# THE RISK OF INCONSEQUENTLY USING THE ACCOUNTING POLICIES

Methodological  
article,  
Qualitative  
research

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## Keywords

Positive analysis,  
Financial risk,  
Entity behavior,  
Accounting policies

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## JEL Classification

D21, D23, D63, D78

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## Abstract

*This research is trying an approach on the risk concepts that appear when using inconsequently accounting policies and management techniques for controlling them. The increase of companies' vulnerability, their size, the huge impact of technology, the global interdependence and competition, the environment awareness, too, are only a few of the factors which are drawing my attention on the issue of these risks and their management. Romania's emerging economy is creating a favourable environment for building a business. The reaching of the established objectives is encumbered by this uncertainty that can be either a barrier or an opportunity for the profitability of the entity. It is envisaged the getting/obtaining of information regarding the state of the phenomenon under study, as anchored in the national economic reality, the exploitation of the information available in the field of interest that is being studied, as well as the exchange of information and good practices.*

### **Romania on the path towards economic convergence**

“Romania could become an emerging market” is stated in an article from the newspaper “Capital”, June 2014 issue.

As part of the evaluation and analysis of the current events, I dare state that Romania’s economy is under economic and financial (re)structuring *which should* provide the internal sustainability, on one side, and the amortization of the external economic shocks, on the other side.

As a matter of fact, the main factor for activation of the real and nominal economy restructuring is the process of (real and nominal) economic convergence of Romania with the European Union.

The analysts claim that from the point of view of the vulnerability of this emerging economy, Romania has an economic and financial structure in process of modernization, with an average dynamics.

Within the context of the post-communist economic and political changes that Romania has been subject to, the accounting faces substance changes, the accounting reform being far from completed.

So far the accounting reform has made three steps:

- adoption of the French accounting model, close to the Romanian concept and theories already in use;
- adoption of the International Accounting Standards (IAS), a British conceptual framework, driven by the agreements with World Bank and International Monetary Fund, as a result of the economic problems after 1990’s;
- adoption of the European Directives, reform started in 2005 in order to become a member of the European Union.

The convergence of the accounting standards has sped up, even if there were and there are still significant challenges.

The international convergence at the level of the accounting standards targets more than 100 states that subscribe to the International Financial Reporting Standards (IFRS).

The globalization that it is aimed at has certainly an impact on the economic life, therefore it leads to the convergence anticipation, which, in its turn, leads to the appearance of the reviewing of the accounting standards. Such reviews are prepared both under the conduct of the International Accounting Standards Board (IASB) and under the conduct of the Financial Accounting Standards Board (FASB) from the United States.

The ultimate test, *the fair presentation*, which is the core of the financial reports with direct impact on the accounting practices, is a concept

that develops as a response to the accounting and commercial practices of the time.

The purpose of the financial reports (statements) is to provide information concerning the performance of the enterprise (the profit that such entity makes from the resources that it controls) and its financial position (its ability to adapt to the changes of the environment where it operates) to the internal and external users.

The financial statements have a general purpose, they contain: annual, interim financial statements, as well as other types of financial reports of general purpose (managers’ reports, associates’ statements, financial analyses, etc.).

In order to reach the purpose of the financial statements, and in order to render them useful for a certain environment, the information providers must find a balance between the specified quality features (comprehensibility, relevance, credibility, comparability).

In order to create a safe environment for all concerned parties, transparency and quality of the data play an essential part, being a precondition of the responsibility and of the internal discipline in the decisional process of the enterprises.

*Transparence enhances responsibility, while responsibility enhances transparency.*

The assumptions that represent the basis for the preparation of the financial statements, the qualitative features of the financial statements and the limitations related to the provision of financial information are presented in the table no.1 below:

### **Accounting policies for small and medium-sized entities within Romania’s current context**

An important part in reaching the purpose of the financial statements is played by the accounting policies of the entity.

Once selected, the accounting policies used for obtaining the general financial reporting must be enforced consistently, for as long as they faithfully present the effects of the transactions and the events of the reporting entity.

The consistency in the enforcement of the rules provides the premises for obtaining the comparability of the disclosed information. However, it is not costless. The costs may be significant for certain categories of enterprises.

The accounting policies cannot be standardized, they must contain both accounting rules and treatments for general operations, and accounting rules and treatments for operations specific to the field in which the entity operates.

The Enterprise Resource Planning (ERP) was conceived in order reach the optimum purpose of an enterprise, by preparation of a full and adequate set of accounting policies.

Even if the Enterprise Resource Planning systems have existed since 1960, the first product being the Material Resource Planning (MRP) that

developed and was perfected into the current ERP, the cost of such software is high. In Romania the providers of ERP include names such as: Oracle, SAP, IBM, Microsoft, etc.

As a result of the high implementation cost, but also of the small number of specialists existing on the Romanian market, the small and other entities use the shortage of such things as a cover for explaining the inexistence (or the precarious existence) of the accounting policies, the lack of transparency of the financial statements, even though such statements are regulated both by accounting regulations (Order no.3055/2009 of the Minister of Public Finance( MFP), subsequently modified and completed) and by Law no. 31/1990, on trading companies, republished, subsequently modified and completed, that stipulates the responsibility concerning the approval of the accounting policies of the enterprise among the administrator's responsibilities that cannot be delegated to the directors.

Therefore, when establishing the accounting policies, the administrators must take into consideration the economic context within which the entity carries out its activity but also the legislative provisions, the applicable accounting regulations.

On the other hand, when establishing the fiscal policies, the entity may choose, just as for the accounting policies, to apply or not to apply certain optional provisions that the fiscal legislation allows to use.

By means of the approved accounting policies, the administrators administer and control the carrying out of the economic operations, which represent the internal "legal framework" of the entity.

The uncertainty, the risk and the increased dynamic of the business environment, corroborated with the failure to pay the due attention to the accounting policies by following the motto ...."forget it, it will also work this way...." but also with the fiscal burden, all may entail the bankruptcy of the entity, a situation increasingly common on the Romanian market.

The inconsistent enforcement of the accounting policies may lead to a failure in reaching the purpose of the annual financial statements that is offering the information required for taking the decisions, by non-observance of the continuity and comparability of the financial statements. It is important for the users of the information (especially for the investors) to compare the information from the annual financial statements of various entities, in order to choose the best investment to make.

The attempt to transmit irrelevant information by minimizing the role of the accounting policies can only create an opaque

imagine of the entity, imagine that the information users will not take into consideration.

One will also lose sight of the practical and the organizational considerations by inconsistent drafting of the accounting policies.

In order to choose the accounting policy adequate for the concerned entity (that will take into account the internal and external factors, so that the financial statements could reach their purpose), it is necessary that the management of the entity should make medium and long-term (3-5 years) assessments and should assess the effects of enforcement of particular accounting policies, because it may happen that certain accounting policies should be adequate only for a medium term, but they may be inappropriate for a long term.

On the other hand, the entirety of the fiscal rules that an enterprise adopts on a long term can be considered the fiscal policies of the entity.

Thus the risk management becomes increasingly necessary.

The risk management is integrated in the general management, being based on:

- operational management;
- management of the essential activities;
- logistic support.

The accounting information provided by the controlling and subsidiary accounts serve the economical and financial analysis as first rank basic material for the preparation of diagnoses strongly based on the economical and financial reality accurately reflected in the concerned accounts (Crecana, C., *Rentabilitatea intreprinderilor mici si mijlocii (Profitability of small and medium sized enterprises)*, Publisher: Editura Economica, Bucuresti, 2000, p. 28).

Taking into account that the accounting information is a support for determining the profitability of the entity, it is obvious that in order to obtain a better profitability at the level of all economic activity, an entity must maximize the economic function of the profit, and to minimize the economic function of the costs (Crecana, C., *Rentabilitatea intreprinderilor mici si mijlocii (Profitability of small and medium sized enterprises)*, Publisher: Editura Economica, Bucuresti, 2000, p. 28).

In the Romanian economic reality the small and medium sized entities seem to have a leaping approach in the fulfillment of both the desideratum of the *fair presentation* and the minimization of the fiscal cost in order to obtain the benefits of the fiscal facilities.

In the attempt to maintain the balance between the accounting policies and the fiscal policies, the entity is most of the times tempted to manipulate the profit, in the sense of the artificial increase or decrease of such profit, by artificial increase or decrease of the income or expenses.

The premises of such manipulations covered by the accounting policies are given by the concepts of probability and credibility of the assessment, which allows the recognition and non-recognition of certain elements as income or expenses.

This practice does not take into account the long term impact of such a momentary decision (fiscal year), which may handicap the entity in the next moment (fiscal year) when, in order to also “comply with” the accounting regulations, the entity modifies again the accounting policies.

The risk that occurs in such practices, threatening the financial health of the respective entity, is obviously the risk of bankruptcy (insolvency), a risk that derives from the (economic) operational risk and the financial risk.

In order to survive and stay healthy, the entity must be aware of such economic and financial risk, must adopt a healthy attitude by real assessment of the risks accompanying its activity, it must look beyond the present moment (fiscal year).

The indicators that express the quality of the economic and financial activity of the entity, that can help in assessing the entity stability and in forecasting the decay of the financial situation of such entity, are the following:

- *patrimonial solvency* that shows at what extent the shareholders’ equity covers the long term obligations and the credits by means of equity elements. The balance value is considered to be 0,3.

- *liquidity*, that measures the capacity to fulfill in due time the short-term obligations by using the available financial resources. It must have greater-than-one units, being a resource that can face the incidents that may occur in the movement of the circulating assets.

- *treasury*, that expresses the capacity of the enterprise to finance itself out of steady resources. A negative treasury entails bank loans for current payments, which shows short-term financial difficulties.

- *rate of return*, that reflects the capacity of the enterprise to make net profit by using the owner’s equity and, in the event of a positive financial leverage, it becomes an instrument to obtain a loan.

In order to get a complete and real image of these indicators, the way of establishing and consistently maintaining the accounting policies becomes essential.

### **Instead of conclusions**

As I stated at the beginning of this methodological research, in the process of (real and nominal) economic convergence of Romania with the European Union, the Ministry of Public Finance (MFP ) published on its site for public debate, as part of the decisional transparency, the

draft regulatory deed Government Emergency Ordinance for modification and completion of the Law no. 82/1991 on accounting, for transposition of *Directive 2013/34/EU of 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 European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.* (The New Directive).

Thus, Romania opted for the introduction of a specific system for small entities in order to reduce the administrative duties of the entities, and implicitly, the costs, including the ones related to the accounting and the financial reports, objectives contained in various communications and resolutions adopted at the level of European Union.

MFP estimates that 94% of the reporting enterprises will benefit by the advantages of the simplifications and exemptions introduced at the community level.

The changes brought by the New Directive also target the entities of public interest, the possibility to opt for another financial period than the calendar year is introduced for the newly set up entities; on this occasion, it is clarified in an explicit provision that it is not possible to submit with the territorial units of MFP several sets of annual financial statements for the same financial period.

Therefore, on the way to the refinement of the professional judgment, the accounting information must be qualitative in order to maintain the social role of accounting for its users in the light of the creation of the added value among the social groups, a balance must be searched between the offer of accounting information (entity, auditors) and the demand of accounting information created by the users of this accounting information.

The establishing of the accounting policies starting from a real basis of the environment where the entity carries out its business, their consistent maintenance for a long time without “*improvising*”, seem to me to be the recipe for long-time survival of an entity.

In order to have an orderly and efficient market, the provision of transparent and useful information is essential, although on a short term it may create discomfort for individual entities, but for a long term it will be beneficial for all participants in the market.

It is preferable that the entities be aware that a healthy financial diagnosis prevents a progressive decay that leads to a difficult situation that the entity may find itself into.

Once the financial decay installed, the road to insolvency is opened.

### Acknowledgment

This paper was co-financed from the European Social Fund, through the Sectorial Operational Programme Human Resources Development 2007-2013, project number POSDRU/159/1.5/S/138907 "Excellence in scientific interdisciplinary research, doctoral and postdoctoral, in the economic, social and medical fields -EXCELIS", coordinator The Bucharest University of Economic Studies".

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Table no.1

<i>Fair presentation</i>	
The objective of financial statements is no achieve fair presentation.	
<i>Materiality</i>	
IFRS only applies to material information. An item is material if its omission or misstatement would change the decision taken by the users of the financial statements.	
<i>Underlying assumptions</i>	
<i>Accrual basis of accounting</i>	<i>Going concern</i>
Financial statements are prepared based on the accrual basis of accounting. Under this basis, transaction are not recorded then they occur and not as the cash flows take place.	Financial statements are prepared on the assumption that an entity is a going concern and will be in operation for the foreseeable future. Hence it is assumed that the entity has neither the intention nor the need to liquidate or materially curtail the scale of its operations.
<i>Qualitative characteristics</i>	
<i>Understandability</i>	
Information should be readily understandable by users who have a basic knowledge of business, economic activities and accounting and who have a willingness to study the information with reasonable diligence.	
<i>Relevance</i>	
Relevant information influences the economic decision of users, helping them to evaluate past, present and future events or to confirm or correct their past evaluations. The relevance of information is affected by its nature and materiality. Information is considered to be material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.	
<i>Reliability</i>	
Reliable information is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. The following factors contribute to reliability:	
<ul style="list-style-type: none"> <li>faithful representation;</li> <li>substance over form;</li> <li>neutrality;</li> <li>prudence; and</li> <li>completeness.</li> </ul>	
<i>Comparability</i>	
Information should be presented in a consistent manner over time and in a consistent manner between entities to enable users to make significant comparations.	

Source: International Financial Reporting Standards, A Practical Guide, Hennie Van et.al, Irecson, 2011