



Sabina-Cristiana Necula

PhD (Economics), Scientific Researcher,
Department of Research, Faculty of Economics and Business Administration,
Alexandru Ioan Cuza University of Iasi
11 Carol I Blvd., Iasi, 700506, Romania
sabina.mihalache@gmail.com
ORCID ID: <https://orcid.org/0000-0001-6912-2450>

Accounting decisions from the perspective of profitability

Abstract. This paper presents accounting decisions in terms of recognition, classification and evaluation. The relevance of the study is determined by the objective of a fair value measurement under the conditions of economic and financial profitability. The author of the article explores the issues relating to the research by considering the Romanian bank sector and using data from 2011 to 2016. The article distinguishes accounting decisions from managerial decisions and reflects the relevant effects on management information system.

The hypothesis identifies the current income-reducing accounting choice and the «net profit» independent variable. In order to test it, it is essential to identify empirically observable data that can be a proxy for such variables. The study considered «provisions for non-performing loans» as the dependent variable. The commonly identified economic factors that might influence a firm's choice of accounting methods are management bonus schemes and leverage. The hypothesis was thus tested by using total bank profits as independent variables.

Keywords: Accounting Decisions; Fair Value; Economic Profitability; Financial Profitability; Managerial Decisions; Raiffeisen Bank; Commercial Bank of Romania

JEL Classification: M10; M40; M41; M49

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Некула С. К.

кандидат економічних наук, науковий співробітник, відділ досліджень,
факультет економіки та бізнес-адміністрування, Ясський університет імені А. Й. Кузи, Ясси, Румунія

Бухгалтерські рішення з погляду рентабельності

Анотація. У статті розглядаються бухгалтерські рішення з погляду їх визнання, класифікації та оцінки. Актуальність дослідження визначається необхідністю оцінки справедливої вартості в умовах економічної та фінансової рентабельності. Дослідження проведено на підставі результатів аналізу банківської системи Румунії за період з 2011 по 2016 рік. У статті проведено розмежування між бухгалтерськими та управлінськими рішеннями з урахуванням їх впливу на інформаційну систему управління.

Ключові слова: бухгалтерські рішення; справедлива вартість; економічна рентабельність; фінансова рентабельність; управлінські рішення.

Некула С. К.

кандидат экономических наук, научный сотрудник, отдел исследований,
факультет экономики и бизнес-администрирования, Ясский университет имени А. И. Кузы, Яссы, Румыния

Бухгалтерские решения с точки зрения рентабельности

Аннотация. В данной статье рассматриваются бухгалтерские решения с точки зрения их признания, классификации и оценки. Актуальность данного исследования определяется необходимостью измерения справедливой стоимости в условиях экономической и финансовой рентабельности. Исследование проведено на основании результатов анализа банковской системы Румынии за период с 2011 по 2016 год. В статье проводится различие между бухгалтерскими и управленческими решениями с учетом их воздействия на информационную систему управления.

Ключевые слова: бухгалтерские решения; справедливая стоимость; экономическая рентабельность; финансовая рентабельность; управленческие решения.

1. Introduction

Romania has been a capitalist country since 1989. After 1989, the country experienced a decade of economic instability and decline caused by its obsolete industrial base and a lack of structural reforms. From a macroeconomic perspective, the Romanian economy has been relatively stable since the year 2000, characterised by high growth, low unemployment and declining inflation. Romania became member of the European Union in 2007. Today it is an upper-middle income country.

The banking sector of Romania is highly concentrated and dominated by foreign-controlled banks. Banks in Romania operate as universal banks.

Financial stability is not put in question, yet the financial sector will continue to face difficulties arising from significant cross-border bank deleveraging and non-performing loans (NPLs), although the situation improved in both these areas in the period of 2014-2015. Romanian banks remain well capitalised and liquid, and maintain reassuring provisioning buffers in the face of continued pressures on asset quality.

Non-performing loans are of interest to this paper, because non-performing loans present an opportunity to create provisions to diminish profits, and therefore banks do not pay any profit taxes. Banks register the accounting profit, whereas the taxable profit is equal to zero due to provisions or registered losses from non-performing loans.

Positive accounting theory assumes that accounting choices are influenced by managerial opportunism (Watts and Zimmerman, 1978; 1986) [17-18]. Given the bank sector climate in Romania, we believe that positive accounting theory hypothesis may be appropriate. This paper is based on a hypothesis that bank managers will make accounting choices in order to reduce the taxable profit.

The empirical study uses an established database of financial information for firms quoted on the Bucharest stock market.

Corporate decision-making processes include decisions related to special orders, adding or removing a production line / product and producing or buying goods (Collier, 2015) [7]. Even if accountants are not managers or decision-makers,

they are involved in making decisions even at the operational level.

Recognition, classification and evaluation of decisions depend on the nature of economic transactions involving resources and/or means. They are situational and more structured than investment or funding because accounting policies are either established when the accounting information system is defined or set by an accounting regulatory body. Any deviation should be mentioned and justified in an explanatory note to the financial statements.

2. Brief Literature Review

The management is responsible for achieving the objectives of an enterprise. Success and survival in a competitive environment require focusing efforts on two goals in particular:

- the profitability of the enterprise, i.e. its ability to obtain sufficient income to attract and retain the invested capital;
- the liquidity, i.e. the ability to cover its short-term payment obligations through the rapid transformation of cash flows (Datar et al, 2001; Moers, 2005) [9; 14].

Decisions on providing information derive from two main concerns of accounting activities: providing financial information and providing cost information. Among the problems posed by choosing an accounting model in providing financial information, we enumerate:

- recognition: rules for value adjustments, for the inclusion of a value in the cost of products, recognition of assets, debts, equity, contingent liabilities, provisions, recognition of subsequent asset expenses;
- classifications: classification of an impairment in the category of adjustments, provisions, contingent liabilities, assignment of a contract to the financial asset or financial liability category, classification of a lease in the financial or operating category.

Cost accounting is reflected in an interface between financial accounting and management accounting (Chenhall, 2003) [5]. Provision of cost information concerns:

- the cost of products and services, determined by using the cost allocation techniques provided by management accounting;
- the marginal cost of some decisional alternatives, determined using the sensitivity analysis technique.

Accounting data have to be:

- identifiable - the accounting data have to be possible to identify in order to obtain information (Luft et al, 2016; Choo, 2000) [13; 6];
- available - the accounting data have to be provided on time.

Often, accountants have to choose an accounting method to accomplish an objective (managerial, financial, related to taxes). For example, when accountants choose between diverse accounting methods in order to reach a specific profit margin, they affect the fair value of information. It is the case of the negative form of the creative accounting (Klein, 2015). In the same context, when the accountant offers alternatives by respecting the fair value of information, it may be a moment when an accounting decision is made.

3. Purpose

The purpose of this article is to present accounting decisions and their relation with managerial decisions. We started from the managerial objective of maximising the profit and defined accounting decisions in terms of recognition, classification and evaluation.

The hypothesis identifies the current income-reducing accounting choice and the «net profit» independent variable. In order to test it, it is essential to identify empirically observable data that can be a proxy for such variables.

The study considered «provisions for non-performing loans» as the dependent variable. The commonly identified economic

factors that might influence a firm's choice of accounting methods are management bonus schemes and leverage. The hypothesis was thus tested by using total bank profits as independent variables.

4. Results

Twenty-seven banks from Romania have not paid any profit taxes over the past six years. It is the unlimited deductibility of non-performing loans (NPLs).

Let us say that a bank has made a profit of EUR 100 million and sold a NPL of EUR 200 million. Generally, the bank sells non-performing portfolios by 5%-7% of their nominal value, yet, according to a study, the average per system is 11%. Thus, the NPL sold is EUR 200 million; the bank collects EUR 22 million with a loss of EUR 178 million. According to the legislation in force, this loss is fully deductible. The institution ends the fiscal year with a loss of EUR 78 million after the expense with the sale of the non-performing portfolio is low on profit. The problem is that losses are rolled over the next fiscal years, from year to year, until the bank reaches zero. This is a cyclical phenomenon. Therefore, a bank declaring a profit for the year does not actually pay any tax, because the reported profit is offset by the losses of the previous year. It is an artifice used by banks to avoid paying taxes.

Under the rational decision-making approach, the accountant, as an information evaluator, chooses information that can maximise its utility function by taking into account the impact of the information signals on the decision-maker's choice (Comyns et al, 2013) [8].

The evolution of the nominal values of non-performing loans and the values obtained from their sale is presented in Figure 1.

Over the past two years, banks have sold substantial NPLs of the population and firms at very low prices, averaging between 8.5% and 10% of the nominal value of loans.

The accountant may be unable to list the set of states, possible actions and possible outcomes. The accountant is often incapable of expressing his/her own utility function for the evaluation of the results or the utility function of the decision maker (Solomon et al, 1995) [16].

Values of input variables are in turn influenced by economic decisions (operating, financing, investments). There should always be a problem, a trigger factor or an alarm condition to maintain decision-making processes.

The analysis of the net profit realised by 46 banks operating in Romania lead to the conclusion that only 18 banks registered profit and paid tax on profit during 2011-2016. Table 1 presents data about the tax on profit paid by banks. We provide examples of only two banks (Raiffeisen Bank and Romanian Commercial Bank) in the table. The source provides data about all the 46 banks operating in Romania.

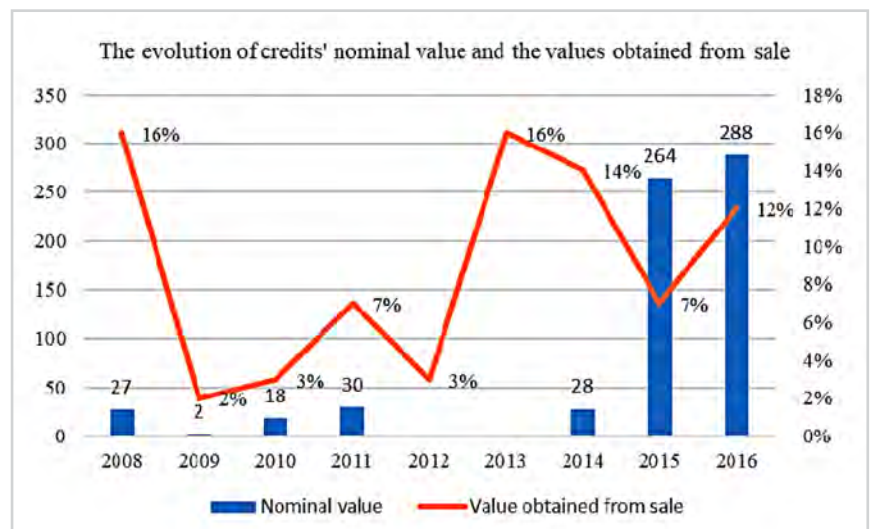


Fig. 1: Evolution of nominal values of non-performing loans and values obtained from their sale in 2008-2016

Source: [11]

Tab. 1: The total profit net and the tax on profit paid by banks in 2011-2016, in LEI

Bank Name	Year	Profit	Tax on profit
Raiffeisen Bank	2011	416,640,994	58,911,578
	2012	466,852,402	66,199,201
	2013	542,567,326	58,101,994
	2014	596,465,327	87,768,414
	2015	868,602,060	83,767,187
	2016	545,937,121	74,552,679
Comercial Bank of Romania	2011	-232,278,422	0
	2012	-1,488,126,490	0
	2013	-117,270,605	0
	2014	-1,186,421,159	0
	2015	1,519,823,932	0
	2016	1,462,080,797	0

Source: Stock Exchange Journal, August 2017, http://www.bursa.ro/_img/articole/mare/328647.jpg

The analysis of economic profitability starts from its determination as a ratio (Formula 1) and then is presented in a graphical form (Figure 2).

$$Re = P_o / A, \tag{1}$$

where P_o is operational profit; A is total assets;
 $\Delta P_o = P_{o_1} / A_0 - P_{o_0} / A_0$ is influence of operational profit;
 $\Delta A = P_{o_1} / A_1 - P_{o_1} / A_0$ is influence of total assets.

Given this model, it is simple to observe that all the banks that registered losses and did not pay profit tax, had a negative economic profitability rate (the negative values are given by the fact that the profit is negative), yet the influence was positive in most cases because even the profit is negative. It tends to diminish from the current year to the next years. Also, the banks have a negative financial profitability (the net profit is negative) with a positive influence for the same reason. The total influence on the bank performance is positive. The only minus is the fact that they do not pay profit tax, because they sell non-performing loans at low prices register the action as deductible expenses, and diminish the accounting profit.

From a simple observation, it can be noticed that the input data required to define the trees are at the lowest level in the management accounts, and at a higher level regarding the input data resulting from calculations, functions and processing of the management accounting data.

While for management models the management involves the organisation and optimisation of models the main data of which are the indicators to be analysed, the metamodel of organising financial accounting information means respecting the true image and the cost-benefit ratio in providing relevant information.

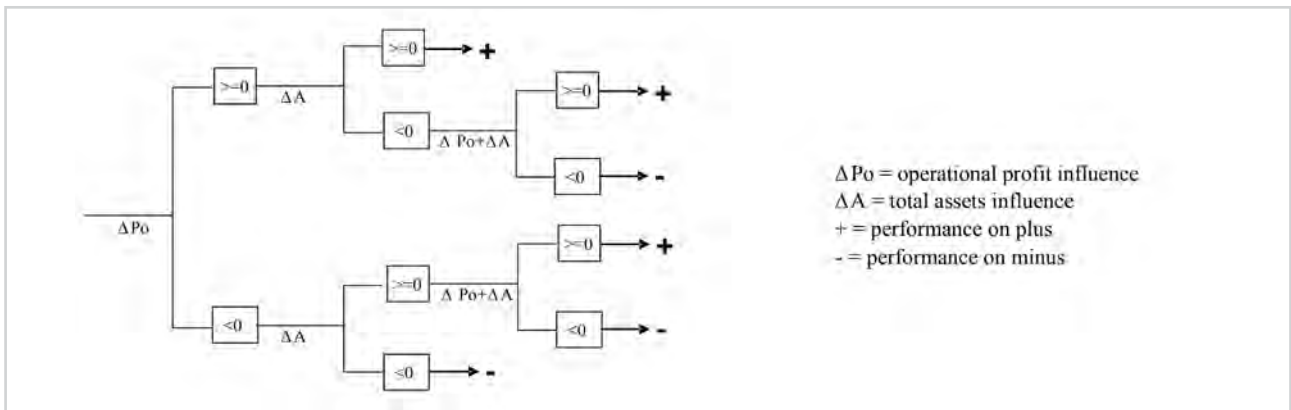


Fig. 2: Economic profitability
 Source: Compiled by the author

The financial profitability represents the capacity of the equities to create incomes, and it is a rate between the net profit and total equities (Formula 2), and then is presented in a graphical form (Figure 3).

$$Rf = P_n / E, \tag{2}$$

where P_n is net profit, and E is equity.

Thus, management models intertwine with models of economic and financial analysis, models of management accounting or economic and financial models. The organisational metamodel is intertwined with management models and does not imply the follow-up of indicators but the establishment of constraints in the recognition, classification and assessment of patrimonial elements in order to attach financial accounting values.

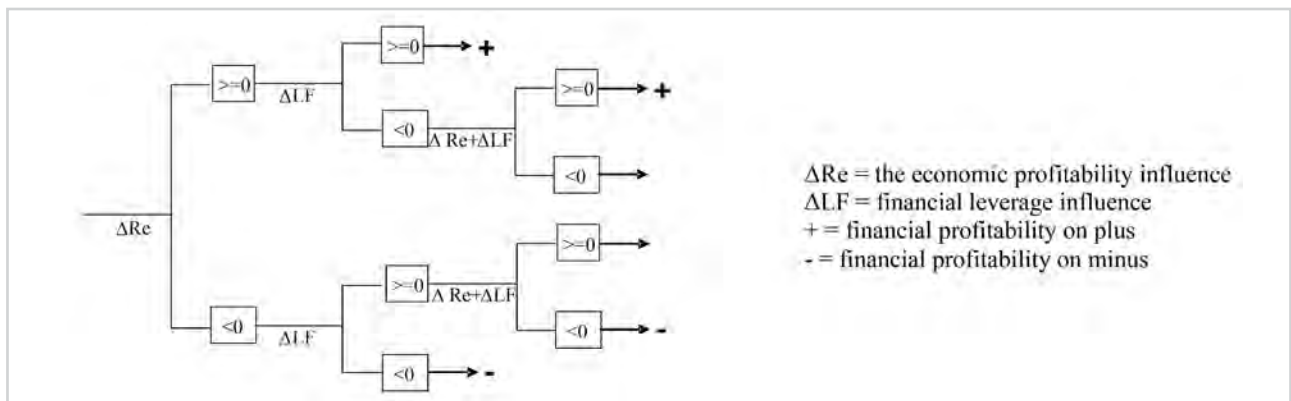


Fig. 3: Financial profitability
 Source: Compiled by the author

Therefore, the accounting decision is any rational choice whose main purpose is to influence (i.e. the form or the substance) the outputs of the financial and accounting system of an enterprise in an identifiable manner. We believe that this definition is sufficiently permissive to include the decision to choose between First-Input-First-Output (FIFO) and Last-Input-First-Output (LIFO) methods for assessing inventory outcomes, the decision to classify finance or operating leases, decisions affecting the level of disclosure in financial reporting and decisions regarding the transition to new accounting standards. Also included are decisions to increase production volume to reduce the cost of goods and services produced by reducing fixed unit costs and decisions to reduce R&D spending to influence profit growth.

The main areas in which accounting estimates and judgments have an important role are as follows: tangible and intangible assets, financial investments, making adjustments for value losses in the case of assets, long-term contracts, determination of contingent provisions and debts, segment reporting.

5. Conclusions

From the operational to the strategic level of management, the accountant makes his/her rationale through budgets and indicators and obtains information through recognitions, classifications and evaluations. The balance between plans/summaries and value estimates/recognition is not the result of rational behaviour, but something influenced by laws and uncertainties, relations with suppliers, customers, employees and regulators. Professional accountability and ethics give the accountant a professional character in ignoring possible personal interests. Nevertheless, the estimates of numerous uncertainties and the outcome of the influence of multiple external factors diminish the ideal rationality proposed by the classical economic models.

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