
The importance of professional judgement applied in the context of the International Financial Reporting Standards

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Abstract

Guidance has always been welcome in terms of applying professional judgement in the context of the principles-based accounting standards – International Financial Reporting Standards. This fact is the result of the complexity and diversity of some situations, which might give rise to difficulties in terms of choosing the appropriate accounting policies and methods (depreciation, inventory valuation on hand at the end of an accounting period, the recognition of revenues and expenses from a construction contract, accounting for lease contracts by the proper determination of the type of lease: financing or operating), and respectively the need to verify if the criteria set by the principles-based accounting standards are met. This “freedom” of choice and disclosure might create problems in terms of accounting information quality. The possibility to select accounting methods based on the Standards’ provisions is meant to generate a true and fair view of the company’s financial position and financial performance.

In these cases it is recommended to use professional judgement in order to reach a conclusion which is in accordance with the accounting principles and is not enforced by any accounting rules, since the exercise of individual professional judgement is preferred against the “pure” compliance with prescriptive legal requirements.

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Introduction

Professional judgment is defined as the application of the accumulated knowledge and experience gained through a relevant accounting or auditing training, by making use of the ethical standards, resulting in making informed decisions about the courses of action that are appropriate in specific circumstances, such as an audit mission and/or the accounting of economic transactions, by observing accounting principles.

The present paper aims to analyse the impact of professional judgement and the role it plays in the preparation of financial statements. We also intend to emphasize the difficulties which arise from the use of professional judgement, in the context of the application of the International Financial Reporting Standards (IAS/IFRS).

Company managers want to present in the financial statements a favourable image of the company's economic reality, while complying with all the accounting principles as stated in the accounting standards (Belkaoui, 2004). A fundamental part of this objective is the engagement of individuals with sufficient knowledge and experience in the process, since they are able to apply the relevant skills and knowledge in order to identify all the reasonable alternatives (Berheci, 2010; Girbină and Bunea, 2008). Therefore, a detailed consideration of information that may seem contradictory and might lead to an erroneous solution is needed, as the key to a proper and consistent application of professional judgement (Feleagă and Feleagă, 2007).

The research methodology used in this paper is a fundamental one, consisting of the analysis of data and previous research results collected from the literature. The purpose of the analysis is to verify the assumption according to which most financial information is processed by making use of the professional judgement. In addition, we have also used a questionnaire in order to verify the auditors' perception about the use of professional judgement in their daily auditing activities.

Another objective of the research is the identification of difficulties in applying professional judgement in the context of IFRS. The desired result of exercising professional judgment is the accounting of financial operations with the observance of accounting principles, by choosing accounting options that lead to the presentation of the economic substance of the items, events and transactions.

1. Applying professional judgment

The judgments made by accounting professionals might be challenged because of the nature of their professional responsibilities and the flexibility of the existing regulatory environment. Different conclusions can be reached in applying the IAS/IFRS, even in similar circumstances, which does not necessarily mean that one conclusion is right and the other is wrong (Ionescu, 2011).

When the professional judgment is challenged, a proper documentation of the used procedures is required, which can show the analysis of the facts, circumstances, and alternatives considered as a basis for conclusions.

Therefore, when the professional judgment process is appropriately applied and documented, it is much easier to support and defend the conclusions. The higher the degree of complexity of a certain problem is, the higher the necessary degree of documentation.

It is obvious that the decisions or conclusions, which are not supported by the facts, evidence, or other documents do not constitute a reliable source. Well-reasoned and well-documented professional judgments is always respected in the case of internal practice reviews and defended in external inspections or other situations, because it emphasises a constructive effort aimed at an adequate reflection of the company's economic reality.

A way to avoid the discrepancies that result by attempting to distort the economic reality is to satisfy the need of unity. This can be achieved by grasping the concept of the primary objective of an economic entity: the maximization of its benefits. There are numerous solutions that are meant to lift any barrier, especially in the case of stringent regulations.

The current concern in the field of accounting regulations is to avoid the subjectivism as much as possible, in order to reflect and provide reliable and transparent information, by making appropriate use of the professional judgement.

Regulation can improve the fundamental principles of the accounting theory, by pointing out what the accounting "should be" (Feleagă, 1996). Accounting regulation has the following objectives:

- To ensure the regulation of accounting policies and to determine ways to improve the accounting, in general terms;

- To allow the users of financial statements to make reasonable decisions based on the provided financial information;
- To create a climate of trust between the owners of capital and the business managers;
- To serve as a “referee” between the parties of the economic life, especially the accounting information providers and the auditors who certify its quality, thus ensuring its reliability.

In this context, there is an obvious need for a thorough analysis of the accounting principles and policies used by an entity, and for an acknowledgement of the advantages of transition from the rules-based accounting to a principles-based accounting, from the concept of the maximum amount of information to the concept of the minimum required information (without a prescribed format for the financial statements), established by the appropriate use of professional judgement.

1.1. Methods of documentation

It is very important to properly document a conclusion, by performing a consistent analysis of the identified problem, the applicable accounting standards, the evidence obtained so far and the alternatives that can be considered within the boundaries of accounting principles.

The applicable questions are:

- Did we properly present the rationale for the chosen alternative by pointing out all the applicable facts that constitute the obtained evidence, including the reason why other alternatives do not adequately reflect the economic and accounting substance?
- Are the time and effort spent in the process and the extent of documentation consistent with the significance and complexity of the results obtained by applying professional judgement in a consistent way?

1.2. Identifying the issue

In this stage it is necessary to act using professional judgment and to consider the following:

- Have we identified and stated the issue appropriately? A proper identification prevents poor performance.

- Are there any other issues that need to be considered in this process? All the related issues can have an impact upon the result and may influence the way professional judgement is applied.

The professional judgement is applicable in a certain context, once there has been obtained a thorough understanding of the relevant facts and all the information is available concerning the transaction, event, or situation. It is certain that the level of performance increases at the same time with the level of knowledge.

The selection of accounting policy and estimation techniques is made with the purpose of presenting information useful and relevant for users, which are in line with the company’s specific activities. IAS/IFRS also place particular emphasis on the need to take into account qualitative characteristics of financial information and the use of professional judgment when preparing the financial statements.

IAS 1 *Presentation of financial statements* requires the companies which prepare the financial statements in accordance with IAS/IFRS to present in the notes to financial statements an organized and systematic description of the applied accounting policies, as well as any exceptions from those policies, through reflecting the results of choosing a certain policy instead of another. Comparative information is also required in the case of changes in accounting policies. The question arises as to how these policies should be selected and it is required to provide a detailed disclosure of the nature, reasons and impact in the case of a possible departure from the stipulated accounting standards.

Furthermore, a change in accounting policy should only be made if the change is required by IAS/IFRS, or it will result in the financial statements providing reliable and more relevant financial information, by providing a comparative preview of the information obtained if the change did not occur in the first place.

1.3. Examples of applying professional judgement

Accounting and fiscal amortization/depreciation

The professional judgement is recommended to be applied, for example, when determining the depreciation method and/or the useful life of long-term assets.

In the case of a pig farm there is a concern for the increase of the production and reproduction performances of pigs. Therefore, the recommended useful life of these assets should be the period within which the purpose of the assets is fulfilled (usually two years and a half, maximum three years). This useful life differs from the one set by the Fiscal Code for this class of assets (four years), which is considered for the purpose of determining the tax on profit.

Therefore, there is a need to reflect the accounting depreciation and the fiscal depreciation separately. It is not accepted to use the useful life set by the Fiscal Code for both the fiscal and accounting depreciation.

The consequences for using a misstated useful life would influence the net book value of an asset and at the moment the sale of the pigs takes place, the net realizable value is much smaller than the net book value, resulting in a higher loss, not consistent with the economic substance of those assets.

Construction contracts

Another case which involves the use of professional judgement is represented by construction contracts, which are accounted for using the guidelines set by IAS 11 *Construction Contracts*. The applicable question is if the results should be accounted for at the end of the contract, or along each stage from the construction process.

The answer has been formulated by using one of the two alternatives: applying the prudence/conservatism principle (scepticism with regard to the way profit is obtained from a contract, meaning that the expected profit can be measured once the contract is concluded) or the matching principle.

The percentage of completion method of accounting is used in connection with the professional judgement in order to determine and account for the outcome of a construction contract, which should be estimated reliably, by recognizing revenues and costs in proportion to the stage of completion of contract activity. The effect of professional judgement in this case is that the expected benefits are determined in the same manner, by using the percent of expenses incurred per total estimated costs, or a physical measurement of the completed activities.

The alternative method (end-of-contract method) limits the measurement of revenues to the amount of

expenses incurred which can be recovered from the beneficiary. Since no profit can be recognized until the contract is completed, professional judgement acts as a mediator between accounting prudence and optimism, in case the benefits from the contract cannot be estimated reliably.

Lease contracts

Lease accounting (applicable standard IAS 17 *Leases*) is another example of how professional judgement is used and it calls into question ethical issues related to the exercise of financial reporting options.

In order to apply the appropriate accounting treatment, a lease must be classified in one of two categories: operating leases or financial leases. In the case of the financial lease, the lessee, benefiting from most economic benefits provided by the asset and bearing most of the risks, controls the asset and must report it in its financial statements, although he is not the owner. For operating leases, payments made by the lessee are reflected as a decrease in profits (expense) in each period.

Incorrect classification of a financial lease as an operating lease causes the understatement of the lessee's assets and liabilities, affecting financial analysis indicators. Presentation of operating expenses and financial expenses is also distorted. Such a wrong classification also affects the lessor's financial statements, but not to the same extent as the lessee's (the structure of assets, operating result and financial result).

The exercise of professional judgement is needed to determine what are the main risks and benefits associated with a lease contract, which involves a detailed analysis of the contract provisions and of the economic reality of the parties involved.

The essence of lease accounting is found in its emphasis on the economic substance of the lease agreement as opposed to the strict legal form of the agreement. To the extent that the lease contract transfers substantially all the benefits and risks economically consistent with outright ownership of the asset to the lessee, the lessee shall account for the transaction as the acquisition of an asset and the incurrance of a liability. This is called a capital lease (finance lease). Alternatively, if the substantial benefits and risks of ownership are not conveyed to the lessee in

the lease contract, the lessee shall account for the transaction as a rental (charge to expense the rental payment each period) and no asset or liability related to the lease would appear on the balance sheet of the lessee, which represents an operating lease.

Professional judgement is applied in connection to the “substance over form” principle related to the above mentioned matters.

Accounting measurement

The professional judgement is also applied in the context of defining the term “value” or for determining the value of an accounting item, which can have multiple meanings: replacement value, net realizable value, recoverable value, fair value, etc., depending on the nature of transaction and the element which is going to be measured; input value, output value, inventory value, depending on the moment when the measurement is performed etc.

One of the most complicated issues associated with accounting measurement is related to the selection of the measurement basis for the elements of the financial statements, so as to ensure credibility and relevance to the information provided. In accounting theory and practice there have been proposed several measurement bases (historical cost, current cost, realizable value, present value, fair value). In order to determine the suitable measurement method for each element of the financial statements, an assessment of the advantages and disadvantages of each alternative is imperative by making use of professional judgement.

On the one hand, standard-setters have concluded that the most appropriate measurement basis is historical cost, due to the advantage given by its reliability, clarity of definition, and verifiability. However, historical cost accounting does not anticipate all of the entity’s profits, because the conservatism/prudence principle does not allow the recognition of the potential gains related to assets, but only that of potential losses. On the other hand, historical cost measurement has its disadvantages, because in a market economy there are price fluctuations, and it is impossible to obtain a correct result in accounting by using a historical cost measurement system.

In many cases, intention is what determines how items are measured, recognized or disclosed in the financial statements. Intent is an element that requires the use of

professional judgment in situations such as: establishing the depreciation/amortization method or the useful life of tangible or intangible assets according to the entity’s intention regarding the use of the asset; selecting the method used to measure inventories at the de-recognition date (first-in-first out or weighted average cost) depending on the entity’s intention regarding the order in which inventories will be derecognized; computing the present value to determine the recoverable value depending on the entity’s intent regarding the use of an asset, etc. Also, setting the input value of an asset, by taking into account the price of purchase as stated on the invoice, plus incidental expenses is based on professional judgment, since the latter must be justified by the criteria of capitalization (result in bringing the asset into its state of operation or use).

The exercise of professional judgment is associated with the freedom of choice regarding the concepts and with the use of options related to accounting policies. The rule limits, while the principle encourages the exercise of professional judgment. The main objective is to obtain reliable information, but because the economic reality is that we have to face the new era of globalization, the limitations of national rules are disclosed by the contrast with the concepts promoted and supported by international standards. The latter stand out due to the freedom offered by the appeal to principles instead of rules, by promoting the exercise of professional judgment and the reliability granted to the standard-setter.

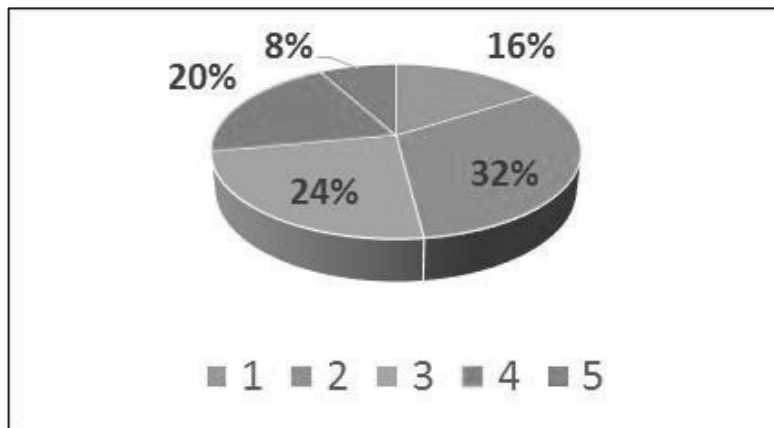
2. The importance of professional judgement

In order to demonstrate the importance of professional judgement, we have distributed a questionnaire to a sample of professional auditors, which determines their position regarding the use of professional judgement. The respondents completed and returned 25 surveys, based on which we performed an analysis of results using a scale from 1 to 5 (1 – totally disagree, 2 – disagree, 3 – neither agree nor disagree, 4 – agree, 5 – totally agree). The primary purpose of the study was to determine the degree of importance associated with the professional judgement.

The questions based on which the results were analysed, the results and the analysis of results are presented in the following paragraphs.

Q1. Does the participation to continuing professional development courses have a contribution to the enhancement of professional judgement?

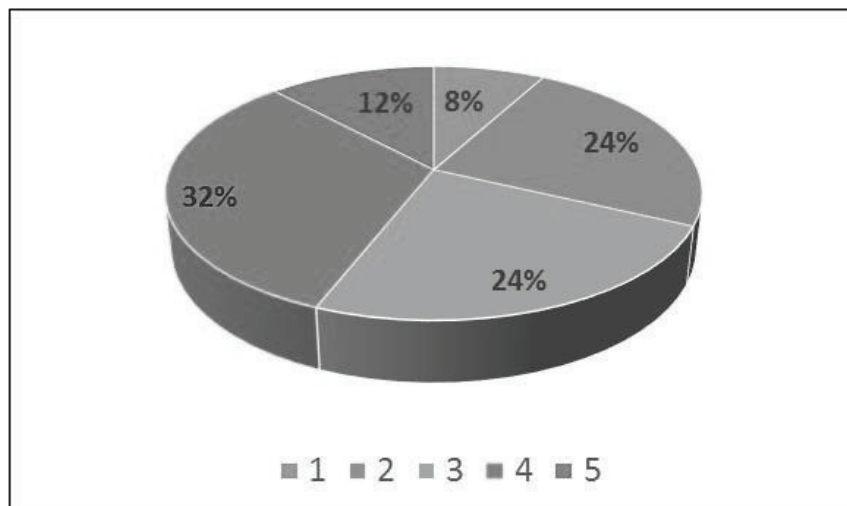
Figure 1. Professional development courses and professional judgement



Source: author's processing based on the answers provided by the questioned auditors

Q2. Does the consistent application of professional judgement contribute to the true and fair view of the financial position and the performance of an entity?

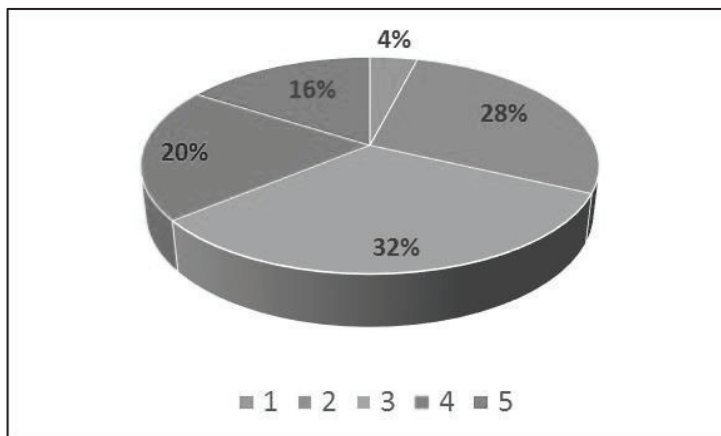
Figure 2. Professional judgement and the true and fair view



Source: author's processing based on the answers provided by the questioned auditors

Q3. Does the application of professional judgement lead to a development of creative accounting techniques and practices?

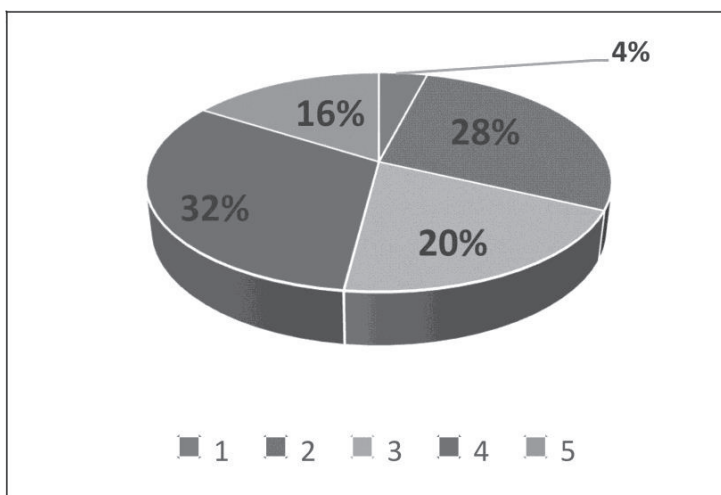
Figure 3. Professional judgement and creative accounting



Source: author's processing based on the answers provided by the questioned auditors

Q4. Do the financial statements prepared based on the IAS/IFRS better meet the users' informational needs as compared to the ones prepared based on the rules established by the national accounting standards?

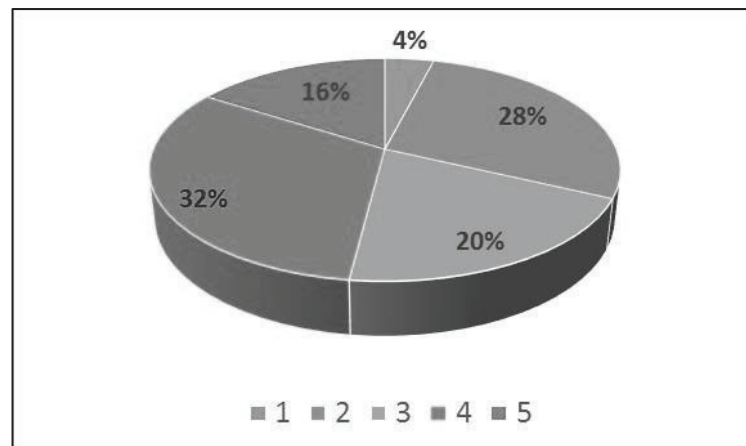
Figure 4. The extent to which the financial statements prepared in accordance with IAS/IFRS better meet the users' informational needs as compared to the financial statements based on national regulations



Source: author's processing based on the answers provided by the questioned auditors

Q5. Does better and more frequently used professional judgement come with greater professional experience?

Figure 5. Professional experience and professional judgement



Source: author's processing based on the answers provided by the questioned auditors

From the answers received from the respondents, most of the auditors believe that the professional judgement plays a very significant role in the reflection of a true and fair view of the company's financial position and financial performance.

52% of the questioned auditors believe that the participation to continuing professional development courses has a contribution to the enhancement of professional judgement, while the remaining 48% sustains that the real case scenarios bring added value. However, other studies (Salter and Niswander, 1995; Frecka, 2008) have demonstrated that the knowledge acquired in the course of university and post-university training, as well as professional development courses organized by companies contribute to the development of professional judgement.

44% of the interviewed auditors believe that the proper application of professional judgement leads to better results in the financial reporting process, while 24% are reluctant due to the subjectivity involved in making a choice and the chances of making the wrong decision.

46% of the subjects agree that professional judgement can lead to the development of creative accounting techniques. This development might have a positive impact, since it can contribute to building proper measures to manage resources in order to achieve performance.

48% of the questioned auditors agree with the fact that the financial statements prepared in accordance with IFRS meet better the information requests of the users of financial statements than the financial statements prepared in accordance with the local generally accepted accounting rules.

Also, most of the study subjects agree with the fact that with greater professional exposure and experience, comes greater professional judgement.

In exercising professional judgment, it is recommended to rely on the accounting policies and treatments stipulated by the national and international accounting regulations, reflecting consistency in the application of accounting options.

Conclusions

The prospect of a reality specific to the economic entity is built on the professional judgment applied both in accounting, to assess how the financial statements are prepared, but also during an audit mission, because the auditor's professional judgment is vital, helping him evaluate the audit evidence collected, in order to be able to justify and support his opinion on the audited financial statements.

Classifying and reporting certain transactions, events or amounts in the financial statements, which result from

complex, dynamic and not clearly defined situations, especially if standards are incomplete, requires a “sound application” of the professional judgement, which best proves its usefulness in these type of situations.

Another characteristic of the nature of professional judgement is associated with the financial consequences of an improper application, such as the case in which the economic substance of a reported transaction or event is disregarded for the benefit of its legal form – leases.

Professional judgement is closely connected with the reliability offered to the users of financial statements, since their decisions are based on the values reported by the preparers of financial statements. The objective is to present information as a result of an adequate analysis, through the application of measurement and classification methods and techniques suitable to each specific entity.

Professional judgement is a key skill for preparers, both auditors and accountants of financial statements, especially under a principles-based accounting regime. However, making a judgement can be difficult and there is not necessarily one correct answer. Being able to make good judgements is the essence of each profession, in general. For example, in the case of an

accountant; the benefit is associated with a high quality financial reporting, once all the transactions of the company have been properly accounted for.

Professional judgement applied in the audit brings added-value by a proper identification of the audit risks and the development of audit procedures, as well as a certain determination of the workload and the evidence required to sustain the audit opinion.

Both professional scepticism and objectivity are essential to the process and to reaching an appropriate conclusion. Professional judgment is not an arbitrary decision, a substitute for professional scepticism, or a method to rationalize a particular result. Performing the process in “form” without focusing on the substance does not constitute well-reasoned professional judgment.

It is important to highlight the role of trust in a principles-based accounting framework. The quality and integrity of the judgements made give rise to correct numbers being reflected in the financial statements and, therefore the trust in the operation of principles-based accounting standards increases once more if the suitable methods of valuation and classification are applied consistently.

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