

# **THE QUALITY AND UTILITY OF ANNUAL FINANCIAL REPORTS BETWEEN EXPECTATIONS AND REALITY**

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**Abstract:** Any company makes its presence felt in the market by providing financial - accounting. Users will be more interested in issuing entity, to the extent that the information provided is attractive and quality, showing favorable results. So any accounting information quality is a measure of objectivity and transparency pursued transposition. Setting targets for financial statements depends on many factors and in addition, there is a universal set of objective, valid for all businesses, whatever the accounting system adopted. Over time, in our country, the accounting system has undergone various changes aimed at ensuring financial accounting information as qualitative targets, so try to bring the national accounting system close to international accounting standards.

From an analysis of the three periods to improve national accounting system, no one can see only instability reform process accounting, which included regulations associated initially with European directives (which is also found in French accounting system), then with IAS and European directives, in order to subsequently take place reversing the order of accounting regulations, putting in this regard, European directives first, and IFRS (whose application is reduced) on the second place, combination that has led to the emergence of contradictory situation in some cases.

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## **1. INTRODUCTION**

The accounting information offer should normally respond to information needs of different categories of users, but in our country the various accounting system changes were aimed mostly the interest of the state. So, after 1990 it imposed a reform of the accounting system by the French model, and after 2000 has started harmonization with EU directives and International Accounting Standards (IAS). Finally, in 2005, it was compliance with European directives, but also with International Financial Reporting Standards (IFRS) for certain types of entities, in falling listed companies and that requirement to draw up consolidated accounts.

Over the last few years, the Romanian accounting system was found in a constantly changing, so that Romanian companies' accounting results are presented in a manner as reliable, clear and complete. So our study aims to identify the main legislative news concerning the presentation of financial information through annual financial statements, highlighting similarities increasingly clearer with the provisions of International Accounting Standards.

Following the accounting regulations we will identify all the categories of annual financial statements drawn up by Romanian entities split also on several categories, depending on size. With this typology, by comparison, we extract the main advantages and the shortcomings of each type of reporting, making the case where any relevant proposals will be conducive to increasing the quality and usefulness of financial statements.

## 2. THE ARCHITECTURE OF INTERNATIONAL, EUROPEAN AND NATIONAL FINANCIAL REPORTING

The image of the annual financial statements was changed at once with economic and financial developments of the entity level involving specific and complex accounting work. So, today, starting from the specific of the entities and scope of normalization we find various structures of financial reporting.

According to *international accounting standards* (IAS 1 *Presentation of Financial Statements*), the entities that falling under their incidence, must prepare annual financial statements according to the following structure:

- ❖ the presentation of financial position at the end of the period or the balance sheet;
- ❖ the income statement and other comprehensive income for the period or the profit and loss account;
- ❖ the statement of changes in equity for the period reflecting the movement in equity arising from transactions with shareholders or not;
- ❖ the cash flow;
- ❖ the explanatory notes, including the notes representing the summary of significant accounting policies.

Withal, this standard provides that the entities applying these rules may draw up additional and binding, certain financial analysis reports, environmental reports or added value. These reports have the capacity to present and explain the main features of the performance and financial position, but also the possible uncertainties facing the entity at a certain time. Thus, we believe these reports, once made, help the accounting information users, interested, in particular, about financial performances of those entities.

In our country, the number of entities that prepare annual financial statements in accordance with the International Financial Reporting Standards (IFRS) is about 80 entities, according to a statement from the Financial Supervisory Authority. Thus, this category of annual financial statements, is made, at national level by companies whose securities are admitted to trading on a regulated market. These entities apply accounting regulations in conformity with the International Financial Reporting Standards (IFRS), together with the Accounting Law and Order no. 1286/2012 updated in order to ensure a high degree of transparency and comparability of these reports. In this way, the communication of financial information in a single language provides the required confidence of users and increase opportunities of access to the capital market. However, in case of multinational companies, allows the application of accounting

principles common to all subsidiaries, something which optimizes the quality of reporting to management, and implicitly internal communication.

The annual financial statements architecture, *at european level*, is required by Directive 2013/34 / EU of the European Parliament and of the Council of 26 June 2013, in congruence with that, they contain: *the balance sheet, profit and loss account, notes and other outbuildings*. Analyzing the appliance of the directive mentioned, we consider that the european standards in domain underpinning movements quite noticeable for harmonization across member states, which concern accounting rules. In other words, these rules are the starting point in terms of preparation and presentation of annual reports, allowing member states which have adopted this directive to adapt their national accounting system, so that the financial information provided be comparable, suitable and sufficient.

Currently, the legal basis of preparation and presentation of annual financial statements is formed, *at national level*, from: *Accounting law no. 82/1991 modified and republished and national accounting regulations in accordance with Directive 34/2013/EU by Order no. 1802/2014, as in effect from 1 January 2015*. Thus, from the above mentioned regulations, the structure of the annual financial reports has five components or three components (depending on the size category of the reporting entities). The complete architecture of the annual financial statements is made up of: the balance sheet; profit and loss account; the statement of changes in equity; the cash flow statement and the explanatory notes set.

### **3. CONSIDERATIONS REGARDING TO THE FINANCIAL REPORTING IN CONFORMITY WITH NATIONAL ACCOUNTING REGULATIONS IN EFFECT**

With the purpose to carry out properly the accounting results of economic activities of an entity and their presentation in the financial statements, are nominated, in the Accounting Law, several operations mandatory that lead to quality information that are obtained, which refers to "the chronological and systematic registration, processing, publish and maintain of information regarding to the financial position, financial performance and other information related to the activity performed, both for internal requirements and also in relations with current and potential investors, financial creditors and commercial customers, public institutions and other users".

Another essential obligation regarding to commercial entities accounting recorded also in the mentioned law (art. 9, paragraph 1), regards the provision information system of appropriate activities using annual financial statements. These summary documents or mandatory reporting, at the end of each financial year, shall be addressed to all recipients of information and is prepared according to specific methodologies so as "to give a true and fair view of the financial position, financial performance and other information related to the activity performed".

We also consider *that this last requirement is a defining characteristic of the object of financial accounting and, implicitly, of annual financial statements or otherwise expressed it constitutes the ultimate goal of all other obligations or attributes incumbent that scientific disciplines*. This opinion is justified, actually, by the names and applicable accounting regulations of the european directive which is assimilated within them. Thus, both provisions title uses the expression according to which, they "relate annual financial statements" and naturally the information they provide, which is a relevant novelty to previous accounting rules (valid until the end of 2014).

This feature suggests convincingly also the fact that to the accounting information and annual financial statements that provide them are assigned new qualitative values, raising their contribution in making decision that they have been adopted at the level of economic entities.

In the context of previous statements we also consider that it is justified to express an opinion regarding the way that can be understood, according to the Accounting Law and Accounting Regulations applicable, **the utility or purpose of the three categories of significant information that annual financial statements provide**. In this regard, we note that in both acts provided mentioned it's seen, equally, that the first two categories of information ensure the knowledge and analysis in decision-making of financial position and respectively financial performance.

But, for the next category of information exists, in regulations invoked different expressions on the order in which they are generated, which may suggest a mismatch, which in reality is apparent.

The Accounting Law (art. 9, line. 1) states that the information concerning "activity performed" and in applicable accounting regulations (art. 17) is stated that they refer to "cash flows of an entity".

In order to avoid a potential confusion regarding these expressions, in sense that the contested legislation would amend the content's text of the law to which it refers, we consider that is benefic the assertion according to that the cash flows relate the activity performed by the entity, but this expression is clearer and easiest to put into practice because it makes direct reference to the entity's business divisions or its subtasks, in the sense of knowledge for each of the inputs or outputs of cash or cash equivalents appropriate to the investment and financing operations.

Regarding to the expression of "accurate presentation" prescribed in the Accounting law can highlight the fact that in the applicable accounting regulations (pt. 24) it is defined using other words, without affecting its content. Thus, this requirement is that the annual financial statements "should provide an accurate presentation of the assets, liabilities, financial position and profit or loss of the entity".

In terms of meeting the requirements of financial accounting and also the object of an accurate image is enlightening also the fact that annual financial statements, although are containing more elements or specific documents they are viewed as a whole. They are, legally, official documents for the presentation of financial-economic activity of an entity and ensure the supply and, therefore, the disclosure of information that relate interest both for this and for interested third parties to engage in the reported activities.

The context of previous statements allows the underlining the fact that can not be neglected the aspect according to which the synthetic documents in question can meet the informational objectives default, only if they contain the forms legally established, and reflect only useful and timely appropriate information suitable to that class size in which it is framed the reporting entity.

This last point needs to emphasize the absolute newness that current accounting regulations contain. Thus, economic entities are reclassified, under accounting aspect, according to three criteria of size (total assets, net turnover and average number of employees during the financial year) in three types of entities (A. micro-entities, B. small entities and C. medium and large entities) and the components for annual financial statements are nominated for each of these categories of entities.

The last aspects are essential and requires some additional information, that are presented, suggestively in Table. 1.

**Table no. 1 - Documents and size criteria concerning the delimitation of annual financial statements**

<b>A. MICRO-ENTITIES</b>		
<b>Size criteria</b>		<b>Documents from the set of financial statements<sup>1</sup></b>
<b>Criteria</b>	<b>Size*</b>	
a. Total assets (euro) b. Net turnover (euro) c. Average number of employees	<ul style="list-style-type: none"> <li>• 350.000</li> <li>• 700.000</li> <li>• 10</li> </ul>	<ul style="list-style-type: none"> <li>a. Short balance sheet</li> <li>b. Short profit and loss account</li> <li>c. Information nominees (4 ctg.)</li> </ul>
* <i>It must be respected the limits of at least two criteria</i>		
<b>B. SMALL ENTITIES</b>		
<b>Size criteria</b>		<b>Documents from the set of financial statements<sup>1</sup></b>
<b>Criteria</b>	<b>Size*</b>	
a. Total assets (euro) b. Net turnover (euro) c. Average number of employees	<ul style="list-style-type: none"> <li>• 4.000.000</li> <li>• 8.000.000</li> <li>• 50</li> </ul>	<ul style="list-style-type: none"> <li>a. Short balance sheet</li> <li>b. Profit and loss account</li> <li>c. Explanatory notes</li> </ul> <p><b>and optional:</b></p> <ul style="list-style-type: none"> <li>• Statement of changes in equity</li> <li>• Statement of cash flow</li> </ul>
* <i>Two of these limits must be respected, but to exceed those from letter A</i>		
<b>C. MEDIUM AND LARGE ENTITIES</b>		
<b>Size criteria</b>		<b>Documents from the set of financial statements<sup>1</sup></b>
<b>Criteria</b>	<b>Size*</b>	
a. Total assets (euro) b. Net turnover (euro) c. Average number of employees	<ul style="list-style-type: none"> <li>• 4.000.000</li> <li>• 8.000.000</li> <li>• 50</li> </ul>	<ul style="list-style-type: none"> <li>a. Balance sheet</li> <li>b. Profit and loss account</li> <li>c. Statement of changes in equity</li> <li>d. Statement of cash flow</li> <li>e. Explanatory notes</li> </ul>
* <i>At least two of these limits (criteria) be overcome</i>		

<sup>1</sup> Each set of annual financial reports that must be submitted to the territorial units of MFP, all one of the category in which the reporting entity fall, shall be accompanied by the following documents: a. **a written statement** of accountability administrator entity for drawing the financial statements and compliance of accounting policies with regulations and providing accurate image and guarantee that the activity will take place under normal conditions; b. **the administrator report**; c. **the audit report**, when it is applicable; d. **the internal control report or auditing committee**, as applicable; e. **proposal for distribution of profit or covering of accounting loss**.

Referring to the information that this table provides are beneficial some clarifications that facilitates understanding and putting into practice.

The value in lei of the first two criteria of size is calculated each year based on the exchange rate of 4.4338 lei / euro, published in the EU Official Journal on July 19, 2013.

The change of the category of any entity and, therefore, the set of documents that comprise the annual financial statements shall be made when, in two consecutive financial years, two of the three size criteria correspond to other categories of entities.

A copy of the analyzed reporting, approved by the GMS, shall be submitted to the territorial units of MFP within up to 150 or 120 days from the end of financial year, as the entities legal system:

businesses, companies/national companies, autonomous institutes, national research/development institutes or subunits based in Romania of foreign legal entities, respectively,

cooperative societies and other legal persons than those above and subunits based in Romania but belonging to companies in the European Economic Area.

The economic entities who have not any activity until the date of annual reporting submit, in this regard, a statement within 60 days.

#### **4. THE SHORTCOMINGS OF INFORMATION PROVIDED BY THE ANNUAL ACCOUNTS AND WAYS TO MITIGATE THEM**

Starting from the annual financial statements typology, previously presented, we ask whether financial information submitted through the components of each set of reporting documents are sufficient and useful and if there are some ways to improve their content.

Therefore, analyzing the composition of each category of financial statements we can say that, although the content of the annual accounts has improved, meaning that for some entities, these comprise in addition to the three basic components, also a statement of cash flows and changes in own equity, this structure is not the optimal variant of the annual financial reports. Moreover, the purpose of the annual financial reports is to provide to users of accounting information the necessary data to enable them to determine, correctly, profitability, liquidity and solvency indicators. The structure of financial statements required by current regulations allows determining these indicators but a thorough analysis of the elements that helps to calculate such indicators can identify some shortcomings, namely:

to calculate the profitability of an entity, certain amounts from profit or loss statement which are provided not serve user needs (eg, provisions and depreciation values are estimates influenced by their specific accounting policies or changes in depreciation methods);

in case of the micro-entities the structure of the profit and loss account was visibly reduced (nine lines), most of the elements of detail being transferred in the informative data form, thus hindering users, how to interpret the information provided;

in the calculation of the liquidity and solvency of an entity based on annual financial statements we believe that for small entities the liquidity can be interpreted, because as no balance sheet or profit and loss are not sufficient to satisfy the users' interests, so it might be necessary also the cash flow statement to clarify certain aspects unidentified in other components;

the annual financial statements are often deformed due to the connection between accounting and taxation;

often professional judgment that occurs in applying the principles and rules of evaluation can generate willful results, and not necessarily the real ones.

Certainly the content of annual financial statements will require continuous improvements, but regardless of the form in which the information financial accounting are presented, they must be relevant, accurate, reliable and complete so as to base economic decisions of both the managers and the others users. Indeed, we note that for certain categories of users, when appropriate, entities provide, in addition to the annual

financial statements also other financial and accounting documents so that the decisions of distribution/coverage of the profit/loss (for managers) or the decisions of lending (for banks) to be taken as closely as possible. We also believe that the economic decisions of users can be improved if the annual financial reports would suffer some content changes.

Thus, one way to improve the content of annual financial reports, we believe that is the mandatory compilation of cash flow statement for all entities because the accounting result determined through profit and loss does not satisfy the information needs of users, required an indicator which clearly reflecting the entity's ability to bring profit.

Assuming that economic decisions of users target the future periods and the annual financial information provide financial information for the period just ended, it can be extracted the need to draw up an estimative situation about the future economic activity. Thus, through provisional information with regard to the future activity of the entity, certain users (investors, creditors) can decide whether the entity analyzed shows interest in the future or not. We believe that such a measure amending the annual financial reports can be as relevant and useful for the category of medium and large entities.

We also consider that to be qualitative and useful, the annual financial reports must be as much improved, so they approached greater interests of enough categories of users and not just for the state, who currently uses the annual financial reports as a taxation tool and not for financial and accounting information.

Therefore, we believe that the annual financial statements present some shortcomings because, in our country, accounting regulations regarding the annual financial statements represent a translation of european regulations, with influences of international standards, which why most of the times these provisions are not interpreted in the right way. So any concerns or limitations of national accounting rules require the use of professional judgment, in the exercise of the accounting profession, so that the reality from the entity to be reflected in the financial statements as accurate and thus the economic decisions can be grounded.

## **5. CONCLUSIONS**

In our country are many entities classified by different criteria, the criterion according to which they differs and how to prepare annual financial reports being the size. So that, according to national accounting regulations in effect, micro-entities prepare annual financial reports with two components, small entities with three components, and medium and large entities with five components. If we classify entities according to their quotation on the stock exchange, we retain that the quoted prepare annual financial statements in accordance with International Financial Reporting Standards and unlisted comply with national accounting regulations according with European directives.

Considering the composition of the annual financial statements according to international reference or national, we can conclude that the format of the annual financial statements with five components completed by medium and large entities is similar to the format of the annual financial statements in accordance with IFRS completed by the listed entities, the differences between these being the content.

We note that to ensure the accurate image of the entities heritage, the annual financial statements are viewed as a whole, even if they contain more components and

specific documents. Thus they are official documents that describe the economic-financial activity of the reporting entities and ensure the publication and the providing of economic and financial information that have interest to users in making economic decisions.

Considering the typology of annual financial statements presented we have identified a number of shortcomings, referring to their composition, but also the amount of the information provided to users and the ability of accounting professionals to interpret and use the provisions of accounting regulations. In this sense, we consider that some measures are useful to mitigate these shortcomings so that the annual financial accounting to provide financial information that satisfies the interests of different categories of users.

As a general conclusion, we can say that irrespective of the annual financial statements type to be drawn up, of the accounting referential whereby they have made or of the shortcomings that they have, in that the accounting information provided through these reporting documents being of quality, useful and meet the interests of users, the professional accountants must use professional judgment, provided that the information presented reflects how accurately the economic reality of the entity.

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