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Study Regarding the Relevance of the Information Disclosed in the Romanian Financial Statement

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Abstract: This study is a comparative analysis regarding the relevant information for current and potential investors of Romania. The information required for this study was collected by applying a questionnaire to 186 investors, of which 42 are current investors and 144 are potential investors. The conclusions of this study revealed that there is not any significant difference between current and potential investors regarding the relevance of the information disclosed in the financial statements.

Keywords: accounting; investors; financial statements; Romania

JEL Classification: M40; M41

Introduction

The purpose of financial accounting is to provide relevant and reliable information for decision making to a wide range of users through financial statements. The provisions of accounting regulations in Romania identify the following categories of users of accounting information: current and potential investors, employees, creditors, suppliers and other trade creditors, customers, government and its institutions and the public. Until the changing of the general accounting framework IASB in 2010, these users were considered as the main recipients of financial accounting information even at the international level. However, finding the impossibility of financial statements of economic entities to meet the information needs of all users has led IASB to change the general accounting framework, thus recognizing as the main users of financial-accounting information only investors and financial creditors.

This study attempts to capture the information needs of current and potential investors in terms of those who participate in the preparation of financial statements: the accounting professionals. The paper begins by providing essential items for financial reporting that are found in the literature, continuing with the presentation of research methodology regarding the empirical study conducted through a questionnaire, with a comparative analysis of the results regarding the position of current investors opposite the potential investors in terms of their information needs and it concludes with the authors' conclusions concerning the information to be disclosed in notes to financial statements of economic entities in Romania in order to increase the information relevance of financial statements.

Literature Review

The large amount of information to be presented in financial statements, especially in the notes to financial statements, may result, in many cases, in the loss of qualitative characteristic regarding the relevance of the accounting information. This is exacerbated when the users of financial statement are not economically savvy (especially in management), leading to the loss of the qualitative characteristic of accounting information regarding intelligibility (Lee & Tweedie, 1975).

Concerning the relevance and the intelligibility of accounting information in the financial statements, Tweedie (1976) states that few shareholders read the notes in the financial statements, most of them finding them very difficult to understand. Moreover, the large amount of information that is required to be presented involves costs for the entity. With these issues, in the UK, the company law was amended in 1985 by inserting a new section that allows simplified reporting (Ward, 1998). Institute of Chartered Accountants of Scotland (ICAS) states that in the preparation of financial statements, the entity should consider the following: (1) financial statements should be correct, (2) financial statements should not contain errors, (3) no frauds, (4) the entity has complied with regulations, (5) the entity was ruled competently (6) the entity has adopted a responsible attitude towards environment and society (Baker & Wallage, 2000).

In this context, the evolution and dynamic of the financial reporting model has to be analyzed in correlation to economic realities (Mustata et al., 2012). However, studies in this area show that the accounting information remains the most important source in analysing the performance of an economic entity (Bartlett & Chandler, 1997; Berry & Robertson, 2006), but its relative importance and the use of accounting information in decision making have changed. In order to be as relevant as possible, financial statements should contain predicted information (Herry & Waring, 1995). Depending on how accurate are these predictions, users can make correct or incorrect decisions.

The improvement of the quality of financial statements can be achieved by disclosing non-financial information on environmental protection and the employees (Admiraal et al., 2009). Thus, other models of financial statements and other purposes for accounting can be defined. Young (2006) believes that these models should provide rather "the health" of the relationships among the economic entity, employees, society and environment than the evaluation of financial position, performance and treasury of the entity. Another aspect very discussed in the last time in financial reporting is on the corporate governance which represents a highly debated topic (Strouhal et al, 2012). For the overall purpose of accounting, the accounting profession has the duty to contribute to the development of accounting policies that are able to turn accounting into an essential tool of leadership (Manea, 2011).

Research Methodology

This study aims to identify information needs of investors, by a comparative analysis: current investors' perception opposite to potential investors' perception. The research methodology used in this study is based on questionnaire distributed to a number of 200 investors who attended training courses in economics. The first question in the questionnaire allowed us to distinguish the current investors from the potential ones. Out of the 200 respondents, 42 are current investors (they currently hold shares), 144 are potential investors (they intend to acquire shares in the future) and 16 are neither current nor potential investors (they neither hold shares at present nor intend to buy shares in the future) which is why they were eliminated.

Most current investors hold shares in a single entity that has fully Romanian capital in order to exercise a long-term control. The percentage of control that current investors hold in the capital varies from <5% until they have control only for half of the respondents.

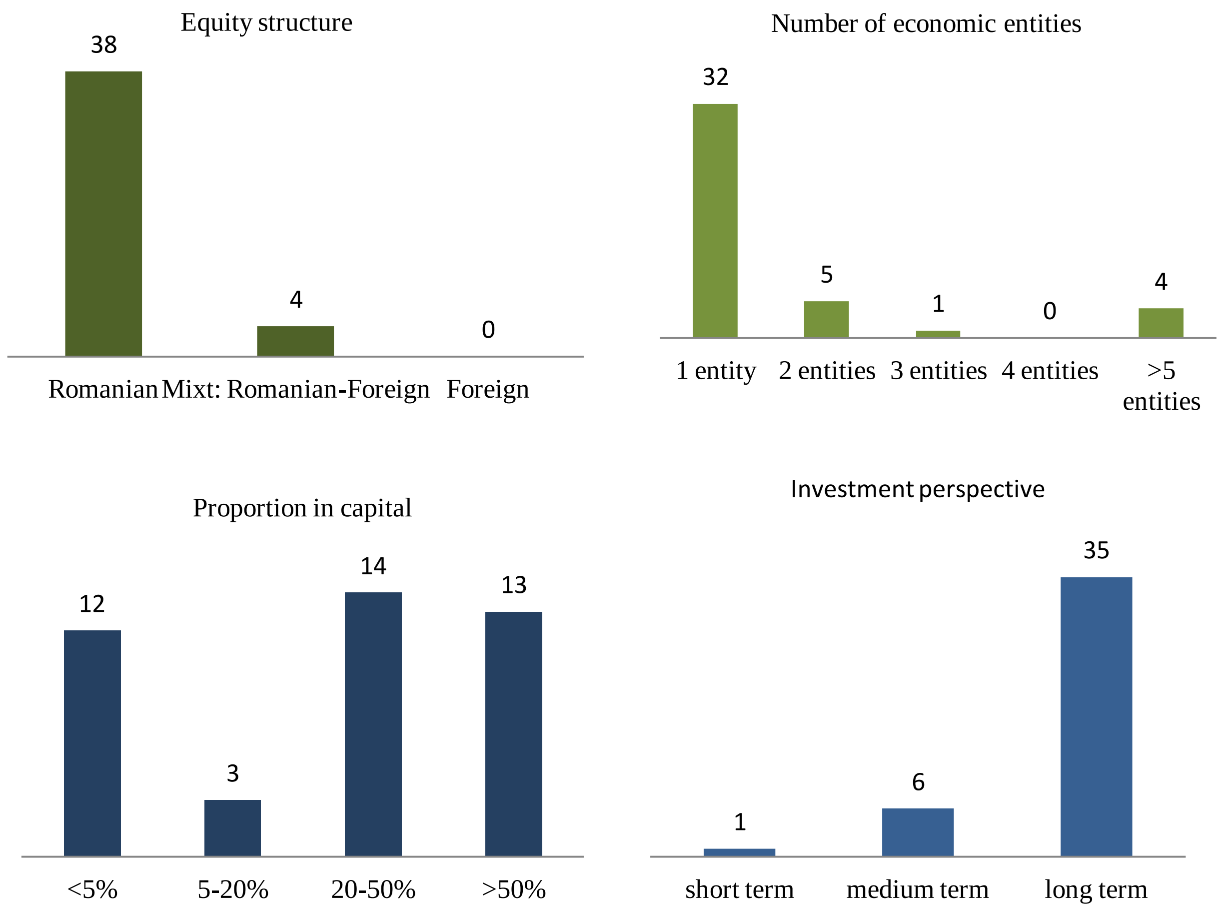


Figure 1. The position of current investors

Regarding the potential investors, as shown in Figure 2, the reason for not holding shares is the lack of financial resources. Because in Romania share investments are considered very risky, investors demand higher profitability ratios of about 40%.

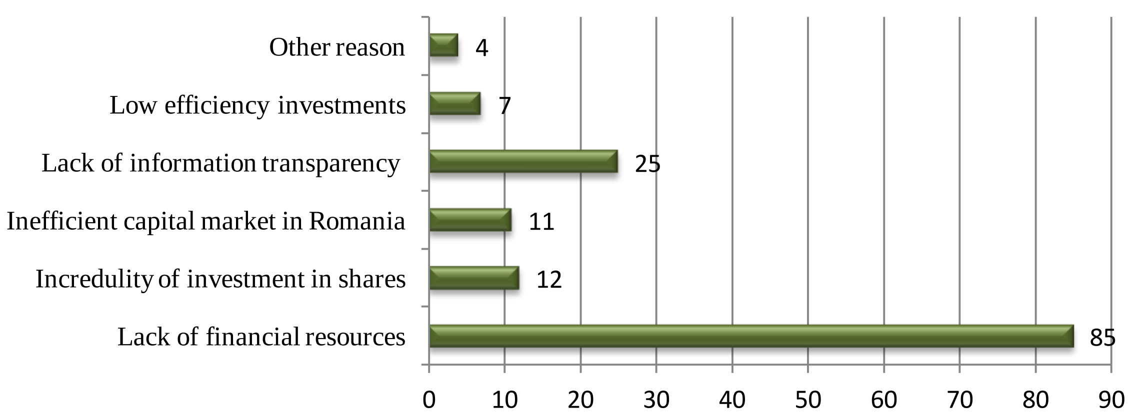


Figure 2. The explanation for not holding shares

To identify whether the requirements of current investors differ from those of potential investors, we set the following assumptions:

A1 The main indicator for assessing the performance is:
a. The economic added value for current investors;
b. The net income for potential investors.

A2 The most important ratios for assessing performance are:
a. The solvency ratio for current investors;
b. The profitability ratio for potential investors.

A3 The type of information preferred to be presented in the notes to financial statements is:
a. Non-financial for current investors;
b. Financial for potential investors.

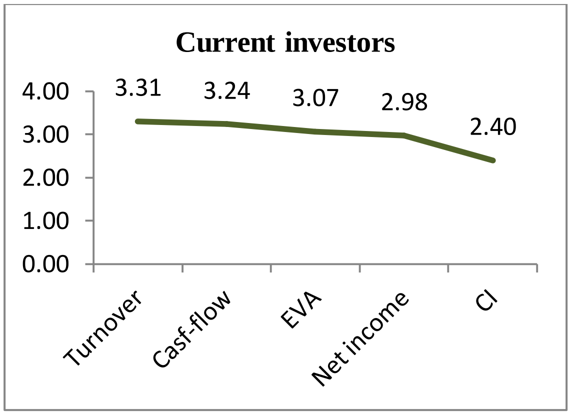
Results and Discussion

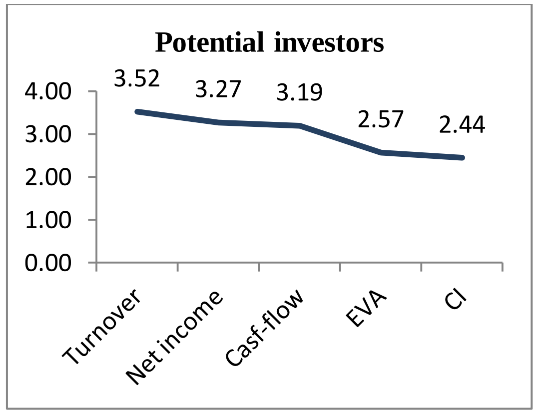
What is the main indicator for assessing the performance of the economic entity?

Today, the term "performance" has some imprecision in use. It is remarkable that, against the abundance of uses, the term "performance" is rarely defined, even in works in which performance is the central subject matter, which is why there are different opinions on the most relevant indicator in assessing performance. The net income was and continues to be today the most widely used indicator in assessing the performance of an economic entity. By its method of calculation, the net income is oriented towards the past, serving as a measure of the progress of an entity during a period of past time. But net income may have other uses: a guide for policy dividends and for acquiring entity; a means of predicting future incomes in order to make investment or disinvestment decisions; a means of assessing the capacity of management to lead the company; a means to assess the value of decisions made by other groups related to the company; a management tool in a number of areas within and outside the company, such as the pricing policy, wage negotiations, credibility in relation to credit agencies, price regulation under monopoly (Olimid, 1998). Given the multiple functions that the net income may have in the analysis of an economic entity, we considered that for potential investors, the net accounting income represents the main indicator for assessing the financial performance of the economic entity.

To assess the entity's ability to continue to produce wealth and value, there must be used increasingly precise instruments that require the orientation towards the sources and origins that create value. The accounting indicators consider that the entity is performing when it obtains profit. But the net income should not only be positive, but it must also compensate the cost of funds brought by shareholders. The result calculated by accounting does not take into account the cost of all factors of production. For the labour factor of production, there is a minimum guaranteed salary. For the capital factor of production, there is as well a minimum remuneration. In academic terms, this salary is called cost of capital (Halpern et al, 1998). If a particular entity earns its cost of capital, it achieved its target. If an entity does not achieve this minimum profitability, and particularly if it does not achieve it in a repeated manner, current investors will be disappointed. It is normal, because their hope of winning, unsatisfied by this entity, could have been done by another. In this case, the entity's capacity to increase will diminish because the shareholders will invest in other investments that are more profitable. Conversely, if an entity earns more than the cost of capital and in a repeated manner, current investors will be satisfied. They will invest more capital in this entity, which can develop very quickly. Therefore, the shareholder, who is always the seeker for the best return of his capital, will focus its interest on entities that create value. It is the reason for which we considered that for current investors, the economic added value (EAV) is the main indicator for assessing the performance, because it takes into account the cost of equity remuneration in evaluating the performance of the entity.

In order to identify the main indicator for assessing the performance of the economic entity by current and potential investors, as alternatives for response, along with the net result and the EAV, we added other three indicators that we considered relevant: the comprehensive income (CI), the cash flow and the turnover. The results obtained following the centralized responses to the questionnaire are presented in Figure 3.





(5 the most important to 1 the least important one)

Figure 3. The importance of financial-accounting indicators in assessing the performance of the entity

From the comparative analysis, it can be seen that for current investors the EAV is a more relevant indicator in assessing financial performance than the net income, as for potential investors, the net income is more relevant than the EAV. As noted in Figure 3, for current and potential investors, the most relevant indicator in assessing the performance of an economic entity is considered to be the turnover. Therefore, both the assumption A1a (*the main indicator for assessing the economic performance is the economic added value for current investors*) and the assumption A1b (*the main indicator for assessing the performance is the net income for potential investors*) are invalidated. The fact that current and potential investors have considered the turnover as being the most important indicator in measuring the performance suggests that for the investors in Romania, the entity's ability to retain customers and to increase their number is more important than the entity's ability to generate a positive result.

There must also be noted the importance that investors attach to cash flow in assessing performance. Obviously, any valuation based on the accounting measures of the result, which is based entirely or partially on conventions more or less removed from the economic realities, is limited and may lead to uncertain data. In the current context of regulation, where there are several options to reflect the same transaction, there is no objective result. Choosing a rule or an option which involves the abandonment of another rule or option, has consequences on the financial statements and on net income. The result may vary among certain milestones without, inside this space, considering a level of result more representative than another one. However, potential investors, especially current ones, being aware of the large enough risks to manipulate the net income, have given high credit for cash flow in assessing financial performance. However, in the era in which the accounting tends to reflect the economic reality, these inconveniences seem to disappear. On the other hand, even if the measures (especially those that are based on cash flow) ignore depreciation and impairments, that are not neutral data, that is, they are determined according to objective criteria and independent from the decisions of the entity’s leaders, they are not considered sufficiently reliable and relevant indicators in terms of economic evaluation.

Regarding the comprehensive income, it was expected that investors would give it the slightest importance in assessing performance, given that on the one hand, this indicator is not known by the investors in Romania because the statement of the comprehensive income is not required for economic entities of Romania, and on the other hand, the novelty of this concept regarding the requirement for economic entities that apply the IFRS to prepare the statement of comprehensive income starting with 2009.

What is the main ratio of appreciation of the economic entity's performance?

The economic entity is based on two goals: to obtain profit and to pay its debts on time. For current investors, honouring debt maturity is their top priority, which is why we thought that solvency ratios are the main ratios to assess the performance by current investors. But for potential investors, investing in profitable entities intends to increase the profitability of the company, which is why we considered that the profitability ratios are the main ratios to assess the performance by potential investors.

To identify the most important ratios for current and potential investors in assessing the performance of an entity, we started from the most important three ratios: profitability ratios, solvency ratios and liquidity ratio. For each of the three types of ratios we have defined 5 ways of calculation, as shown in Table 1. To test the second assumption, we consider that the ratio with the highest score is the ratio preferred by investors in assessing performance.

Table 1. The investor's perceptions regarding the importance of ratios in assessing performance

The name of the ratio	*The method of calculation*	*Current investors*	*Potential investors*
Profitability ratios			
Margin ratio	$\frac{Cost\ of\ sales}{Turnover}$	2,74	3,02
Profit ratio	$\frac{Net\ income}{Total\ income}$	3,76	3,80
Operating result ratio	$\frac{Operating\ result}{Operating\ incomes}$	2,98	2,86
Profitability of assets	$\frac{Net\ income}{Total\ actif}$	2,64	2,54
Profitability of equity	$\frac{Net\ income}{Total\ equity}$	2,88	2,78
Solvency ratios			
Debt ratio	$\frac{Total\ liabilities}{Total\ actif}$	3,76	3,72
Solvency ratio	$\frac{Total\ liabilities}{Total\ equity}$	3,79	4,06
Long-term debt ratio	$\frac{Non-current\ liablities}{Total\ actif}$	2,52	2,69
Short-term debt ratio	$\frac{Current\ liabilities}{Total\ actif}$	2,90	2,76
Interest coverage ratio	$\frac{Operating\ result}{Interest\ expense}$	2,02	1,76
Liquidity ratio			
General liquidity ratio	$\frac{Current\ actif}{Current\ liabilities}$	2,81	2,89
Current liquidity ratio	$\frac{Current\ actif-Inventories}{Current\ liabilities}$	3,55	3,31

Quick liquidity ratio	$\frac{Current\ actif - Inventories - short\ term\ investments}{Current\ liabilities}$	3,21	2,97
Immediate liquidity ratio	$\frac{Liquidities}{Current\ liabilities}$	3,67	3,44
Total liquidity ratio	$\frac{Total\ actif}{Current\ liabilities}$	1,71	2,39

(5 the most important to 1 the least important one)

It is worth noting that both current investors and potential investors have the same perception regarding the importance of ratios in assessing performance. As shown in Table 1, the most important ratio in assessing the performance is the solvency ratio. Then follows, in order of importance: the profit ratio and the immediate liquidity ratio. Therefore, assumption A2a was validated (*Solvency ratios are the main ratios to appreciate performance by current investors*) and the assumption A2b was invalidated (*The profitability ratios are the main ratios to assess the performance by potential investors).*

Is non-financial information useful for current and potential investors?

A particularly important role in the analysis of an economic entity belongs to the notes to the financial statements which should be given attention as important as to other financial statements. In Romania, the notes to the financial statements continue to be considered insignificant, which is why their information content is weak. However, as shown in Figure 4, 44-45% of questionnaire respondents felt that the information contained in the notes to the financial statements in Romania are sufficient. Opinions were however divergent, since approximately 30% of respondents considered that the notes provide summary information and approximately 20% detailed information.

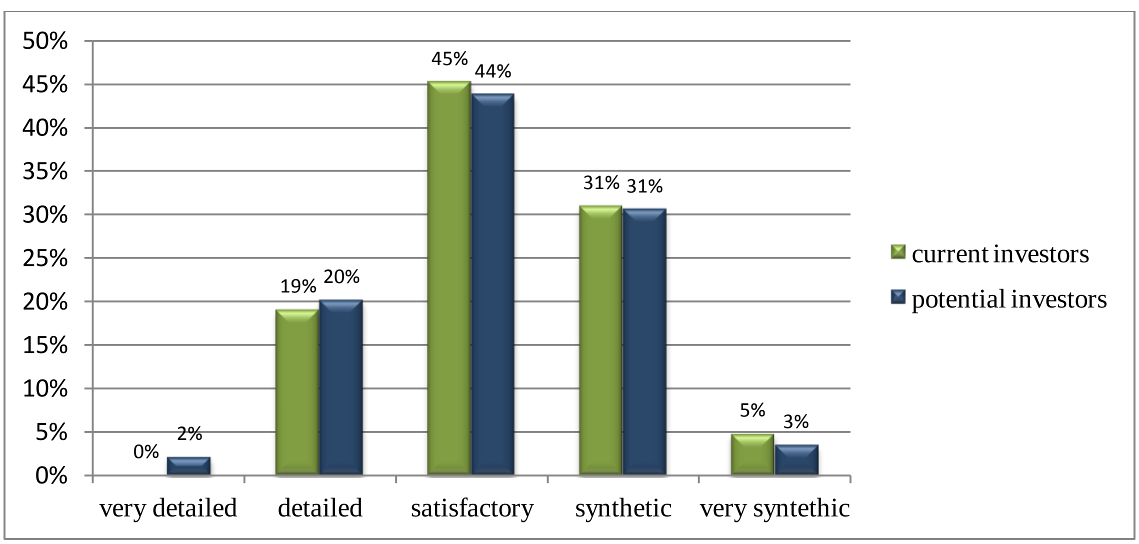


Figure 4. The investors' perception on the information content in the notes to financial statements

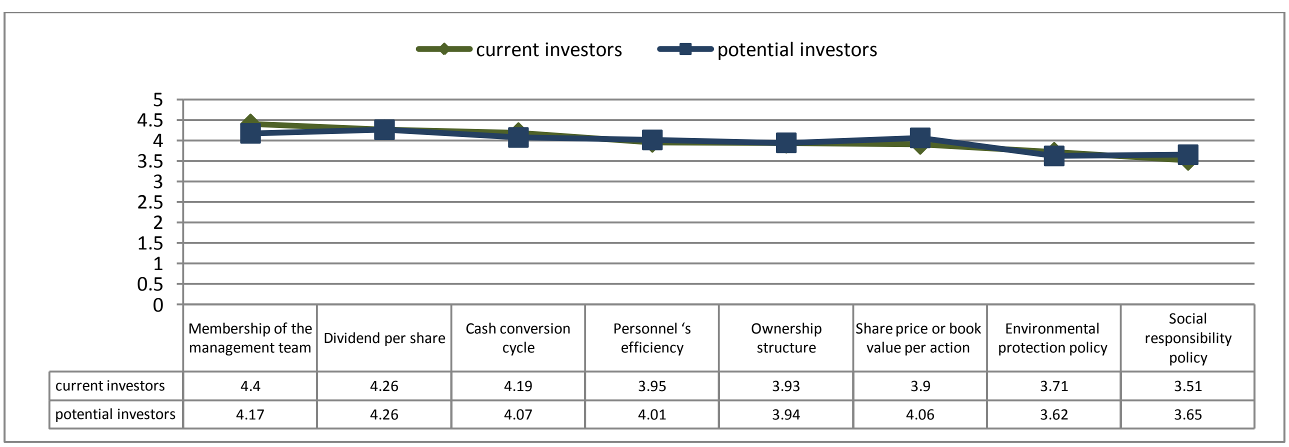
To identify if the information contained in the notes to financial statements are sufficient or detailed, respondents were asked to identify the extent in which it is necessary for other financial or non-financial information (induced by the authors) to be disclosed in the notes. It was surprisingly to find that most respondents (even those who felt that information in the notes was sufficient or detailed) considered to be very important the presentation in the notes of the following financial or non-financial information that is presented in Table 2.

Table 2. The investors' perception regarding the importance of improving information contained in the notes to financial statements by using other financial/non-financial information

Current investors				*Potential investors*			
Order of importance	***Nature of information***	***Information***	***Importance***	***Order of importance***	***Nature of information***	***Information***	***Importance***
1	Non-financial	The members of management team	4,40	1	Financial	Dividend per share	4,26
2	Financial	Dividend per share	4,26	2	Non-financial	The members of management team	4,17
3	Financial	Cash conversion cycle	4,19	3	Financial	Cash conversion cycle	4,07
4	Financial	Staff efficiency	3,95	4	Financial	The course of action or the math book value per share	4,06
5	Non-financial	The structure of the ownership	3,93	5	Financial	Staff efficiency	4,01
6	Financial	The course of action or the math book value per share	3,90	6	Non-financial	The structure of the ownership	3,94
7	Non-financial	The environmental protection policy of the economic entity	3,71	7	Non-financial	The social responsibility policy of the economic entity	3,65
8	Non-financial	The social responsibility policy of the economic entity	3,51	8	Non-financial	The environmental protection policy of the economic entity	3,62

(5 very important to 1 unimportant)

As shown in Figure 5, it is noticed the close importance that current and potential investors attach to non-financial and financial indicators induced by the authors. This comes to strengthen the belief that there are no significant differences between the perception of current and potential investors to measure the performance of an economic entity.



(5 very important to 1 unimportant)

Figure 5. The investors' perception regarding the importance of improving information contained in the notes to financial statements by using other financial/non-financial information

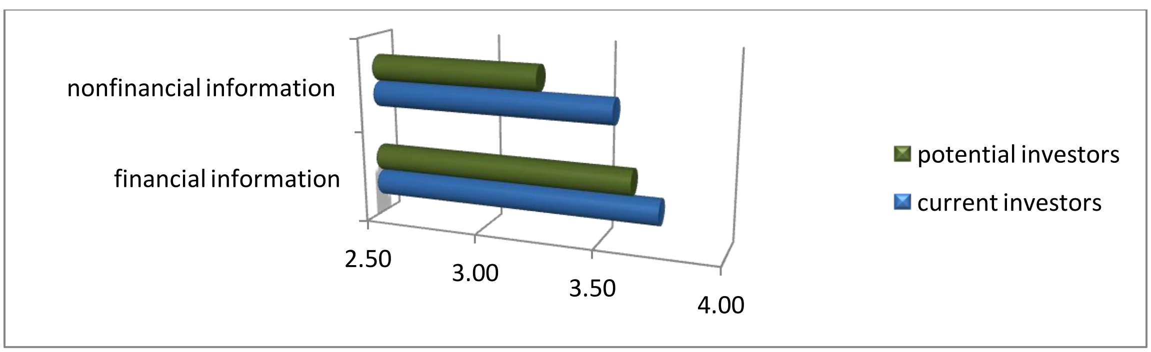
Along with the information induced by the authors, respondents to the questionnaire, based on open responses, identified other financial or non-financial information that entities should disclose in the notes to financial statements. Financial information refers to: financial indicators such as EBITDA, added value, cash flow capacity, etc.; information on costs incurred, respectively anticipated for the research-development activity; financial information related to the management team; information on salary expenses and also on future investments in personnel; presentation of an analysis of main indicators over time and also among entities in the same sector; expected information and also financial information necessary for risk estimation; other types of financial information. Non-financial information is very diverse, such as general information, for example organizational culture, political impact, market shares, etc.; non-financial information related to the management team; information about activities undertaken by the entity in order to stimulate employees; the presentation of customers on main structures and also of price offers; expected information on capital growth; the presentation of the strategy and the risks specific to the entity; other non-financial information. A summary of this information is presented in Table 3.

Table 3. Other financial/non-financial information relevant for investors

Financial information	Non-financial information
Indicators	**General data**
Profitability ratio	Organizational culture
Solvency ratio	Processes that make the object of activity
Liquidity ratio	Applied accounting policies - as detailed as possible
EBITDA	Market share
Added value	Political impact
Economic added value	Information on the group to which the company belongs
Capacity of cash-flow	Organization of the management positions
	ISO Certifications
Research - development	
Expenditure on research and development	
Budget available for market research, innovation, technology	
Management	**Management**
Situation of debts towards shareholders/associates	The readiness of administrators, directors, etc.
Remuneration of management, on main compartments	Information on how often and how much employers appeal to loans granted by them for the company
	Education level of managers, social status, these representing the business card of their company
	Control of the management team
	Experience of management leadership
Employees	**Employees**
Salary cost in relation to the number of employees	Information on the activities performed by the company in order to stimulate the employees, apart from the monthly negotiated salary (recreational, group, professional development activities)
Wage structure of the company (max/min)	Information on different facilities (car, mobile phone, vacations or trips paid by the company)
Investment in personnel	Structure and the qualification of the personnel
Budget for training the employees	Fluctuations in personnel
Comparison over time	**Customers**
Evolution in time of the net incomet for several previous financial years	Structure of customer, strategic customers, their profile, share
Comparable information regarding receipts/payments related to prior periods, mainly customers, suppliers;	Price offer

Evolution of share prices	
Comparison between branches/sectors	
Indicators of profitability in the sector	
Anticipation	**Anticipation**
Anticipations of revenue and expenditure budgets for the next years (1-2 years)	Investment strategies
Estimation of future interest calculated for loans	Intention to increase capital
Value of anticipated future losses	
Risk	**Risk**
Total value of contracts that affect the financial statement of the company for a term that exceeds one year	Major risks that the company is facing
Financial impact of management transfer from the mandate of an administrator to another one	Backup plans in case of risk of bankruptcy/insolvency
Recoverable value of assets held	Market risk, information on major competitors
Value of guarantees, mortgages	Risks that may arise in the future course of activity
Value of fines and due penalties and of the related causes	
Other information	Other information
Total expenses, including deductible, non-deductible	Information about activities that the company carries, but which are not required by the subject or by activity or by law (e.g. social, environmental activities, etc.)
Percentage of taxes and contributions paid in the total turnover	Details of major events that took place in the company: fusion, division, change of ownership
Information on interest loans that were taken by the company and the market interest at that time	Degree of relatedness between main positions from the organization
	Policy of distributing dividends

The notes to financial statements present both financial information and non-financial information, but the share of non-financial information (if we refer only to those required by accounting regulations, namely Order 3055/2009) in all the information presented is insignificant, for which reason we considered that for current investors, the favorite type of information to be presented in the notes is the non-financial one. However, potential investors seeking to invest in the highest profitable shares are mainly interested in financial information. But, as seen in Figure 6, both current investors and potential investors consider the financial information disclosed in notes to financial statements more important than the non-financial information.



(5 very important to 1 unimportant)

Figure 6. The importance of information disclosed in notes to financial statements

The reasons for which both current investors and potential investors considered the financial information as more important than the non-financial one is because at present, in the notes to financial statements, non-financial information is almost non-existent, which makes investors not to realize their importance in assessing the performance of economic entities. Because both current investors and potential investors consider financial information as more important than non-financial information, assumption A3a is invalidated (the type of information preferred to be presented in the notes to financial statements is the non-financial one for current investors) and the assumption A3b validated (the type of information preferred to be presented in the notes to financial statements is the financial one for potential investors).

Conclusion

The findings revealed that there are no significant differences between the perception of current and potential investors in terms of the relevance of financial-accounting information. From the comparative analysis, it has been observed that for current investors, EAV is a more relevant indicator in assessing financial performance than the net income, as for potential investors, the net income is more relevant than the EAV. However, for both current investors and potential investors, the turnover is considered as the most relevant indicator in assessing the performance of economic entities. Study results showed that solvency ratios are the main ratios of assessing the financial performance for both current investors and potential investors. Moreover, it has been seen a preference to present the financial information for both current investors and potential investors. Regarding the limitations of the study, we can mention those of a questionnaire-based study, reflected by the lack of flexibility, lack of control on the analysed environment, the inability to grasp the spontaneous reactions, the subjectivity in interpreting responses.

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