

## **Professional reasoning in accounting and fiscal practices**

*Prof. univ. dr. Magdalena Negrutiu  
Lect. univ. drd. Traian Ovidiu Calota*

The need for alignment to the European directives and international accounting standards resulted in changes in the fiscal and accounting system in Romania, changes which occurred with an almost remarkable speed. As a science, technique, language of communication, the accounting should reflect economic reality and as a consequence, has to answer to the anticipation attempts of the need for information. As an "art" for transactions and events registration the occurrence of differences between what science has accumulated and preserved and what is applied in practice is possible.

Also harmonizing the fiscal system in Romania with the European tax systems determined frequent changes of the legal regulations in this area.

In terms of accounting regulations, the alignment of the European and international referential was initiated much earlier than the one initiated by the national tax system. Therefore, the non-synchronization of the accounting and tax regulation harmonization effect in Romania can be found in the difficult interpretation of these with direct risks related to involuntary tax evasion and also providing a "distorted" image of the fiscal and accounting performance.

Legal regulations, overall knowledge, creativity, management, entrepreneurial skills, the spirit of innovation are all factors which apply in practice contributing to the reflection of the economic reality by reporting science or "cosmetizing of the financial position and of performance".

Our study aims to highlight mechanisms of reasoning for accounting and / or fiscal interpretation of some economical-financial transactions and events.

### **Professional reasoning in accounting and tax practice**

Working in accounting involves the collection of primary documents that contain information regarding economic and financial transactions and operations conducted by the economic entity, their registration in accounts and synthetization in economical-financial reports.

Registration in the appropriate accounts require application of professional reasoning, "mental operation by which two or more judgments result in a new judgment which logically arise from the first two".<sup>\*1)</sup>

The reasoning is exercised on the basis of contracts concluded between the parties, on explanations from documents, work situations, minutes, etc.

The existence of some alternative accounting policies give the possibility to present the favourable image of the financial position and of the performance or less favourable. The accountants can use the principles, rules and conventions in one way or another, in order to discover certain flexibility of the rules or to distortionary approach the image of the company.

By applying a different judgment, the results generated by economical-financial transactions and operations can be handled, often without breaking the law and the accounting rules. Therefore, processing the accounting figures may lead to cosmetizing the reporting situations, so that they reflect exactly the image that managers or owners wish to submit.

Why would they want such an effect?

The answer is simple and can be summarized as follows:

- A bank loan is desired and the result must necessarily be "profit";

---

\*1) DEX online

- Shares are sold / participating shares are transferred and the new investors must "determine" a performant financial position and a favorable result;
- The minimization of the profit is desired in order to pay a lower tax to the state;
- the desire to be part of top companies or providing incentives to managers depending on the size of the turnover obtained, can lead to "adjusting" the reported turnover;
- Cosmetizing the company's assets will lead to handling of the acquisition / production cost.

And the list goes on. Our study will be focused on a few cases from accounting and tax practices, which shows that the companies can get to know or not an intensive development if they use the employees' knowledge that can generate high profits and competitiveness on the market but, at the same time, higher income for the state.

In a financial-accounting perspective, the intellectual capital ensures to the production of financial and accounting information greater efficiency, allowing reliable information but also the use of "creative" accounting.

We will collect and comment information from the companies practice.

1)

1) A transport company plans to take a bank loan. The lending institution will condition the granting of the credit with the profit existence. The company performs during the year, capital repair of the entire fleet and the sum will be in amount of several hundred thousand lei. Recognition of the amount in the account "Profit and loss" leads to a negative result - loss. To avoid such a loss professional reasoning is heading towards expenses in advance, which will be updated in the subsequent years. Repairs expense under accrual accounting recognized at the trade date is staggered over five years. The company obtains the bank loan, the shareholders may take the dividend, the state collects income tax and the dividend tax, and so all partners are satisfied.

But economic reality is not reflected in financial statements during the 5 years, so professional reasoning was applied contrary to it.

In addition it leads to fraudulent bankruptcy for shareholders (on the basis of unjust enrichment). Although the company has had background check in the second year, the fiscal authority has accepted the solution due to the taxes collected by the state.

How can we avoid this and get the same result: by creating provisions for future expenses for 4 years before the date of repair.

2) A company producing garments, funds its operating activities from a credit line. Prerequisite for obtaining it is to obtain profit. And here's how to get it. We know that the production cost includes expenses that are directly attributable to manufacturing. The company does not meet the rule because the stock remained at the end of the period is relatively high and has every incentive to include in its value as many expenses so that profit will result. If we analyze the cost structure we find in it: under activity expense relatively high because the company is working at 80% of the production capacity, protocol expenses, advertising, listing the general direction and even expense for clothing packaging. This distorts the economic reality in order to keep foreign financing source.

3) A real estate company that owns three office buildings made expenditure of several hundred thousand lei, representing: - current repairs in proportion of 60% of the amount spent and modernization expenses in proportion of 40% from the same amount. Under legal rules, the current repairs are recognized as Maintenance and repair expense to the "Profit and loss" account and the amount for modernization is included in the cost of the building. The company included both types of expenditure in the value of the building to stagger by amortization and to avoid the significant decrease in profit for the fiscal year.

4) A company buys a building and land in total amount of 5,000,000 RON, for demolition of the building and construction of another building. The remaining value of the demolished building is in amount of 3,000,000 lei, and the expenses with demolishing amounts to 1,000,000 lei. Accounting treatment prescribed by the legislator for the 4,000,000 lei is the recognition of an expenditure arising from operations with capital, while from a fiscal perspective non-deductible expenses, because they are not expenses made in order to obtain taxable income. To avoid sudden diminishing of the accounting results, but also for tax recovery of costs incurred in building demolition process, the managers choose to capitalize these expenses in the cost of the new constructed building, expense which will be recovered by amortization, tax, deductible also from a fiscal point of view.

5) Even if, in general, billing services provided by construction companies are based on works situations, fiscal and accounting regulations on income recognition and their size are not sufficiently explicit to

establish a direct correlation between the time of billing and the date when the revenues need to be recorded. For example, paragraph 215 from Annex 1 to OMF 1752/2005 provides that "revenues are recorded in accounting while they are accomplished", while execution of the not invoiced works by the end of the period are found in the account "services in progress "on the basis of revenues from stored production. Since there are no other specific regulations for the analyzed domain and the accounting regulations are confusing, the method of evaluating services comes to the responsibility of the accountant's professional reasoning, the accountant being able to choose between recognizing revenue at the effective costs associated to the stage of the works or recognizing revenues in proportion with the stage of the works. Because the treatment of income tax which are taken into account when determining taxable income, take into account the income recorded in accounting according to accounting regulations, we conclude that their fiscal recognition depends on the tax application of accounting regulations and not on the tax regulations. Thus, in the case that maximizing the profit is aimed, the practitioners will be tempted to use advanced percent methods by budgeting higher than it is the case, or by "adjusting production costs, that is an increase in production cost increase with elements which in a real situation cannot and should not be found as a component in the manufacturing costs underlying the Revenue of stored production.

6) Let's consider the following transaction, knowing that until 31.12. 'N' the manufacturer has sold to a supermarket goods in amount of 2,000,000 lei, VAT 19%, cost of goods delivered 1.800.000 lei. Remark: Under the contractual terms, the manufacturer is obliged to grant a reduction of 9% from the value of the goods, if the volume of sales between the two partners is higher than the amount of 1,400,000 lei, VAT 19%. Therefore, on 15.07. "N1 ", the manufacturer issued the bill of 9% reduction that is 180,000 lei, VAT 19% for the financial year., N". Contractual obligation was fulfilled at the end of the year, in which case it was necessary for the manufacturer to reduce its turnover in the same year. However, the accountant did not registered the commercial reduction in the exercise "N", but the following year, an "error" took place whose incidence in the financial statements of the Year "N" is presented below:

Elements	Financial /fiscal Reporting dated 31.12."N"	Financial/fiscal Reporting Correct	Reporting Differences
Total revenue	10.000.000	9.820.000	+ 180.000
Total expenses	9.840.000	9.840.000	0
Accounting/ fiscal result	160.000	- 20.000	+ 180.000
Tax on income 16%	25.600	0	+ 25.600
Accounting net income	134.400	-20.000	+ 154.400

Indeed, the manufacturer reported in year "N" a taxable income of 10,000,000 lei, while the correct taxable income would have been 9,820,000 lei, if the reduced sales were recorded in December in the fiscal year "N", which led to other effects:

- reporting a profit before tax bigger than the amount of 180,000 lei;
- reporting a net profit bigger than the amount of 154,400 lei;
- declaration and registration of a higher income tax bigger with 25,600 lei.

a)

In all these cases professional reasoning was applied outside the legal rules so as to achieve the desired result. We cannot meet legal standards, and still get "favorable image" that a company wants. Thus we provided services / works performed, but the customer has not yet registered the reception.  
a) We aim profit, recognize the selling price in the account "Profit and loss", using the account "customers-invoices to be replaced".

- b) We want an insignificant loss, recognize the revenue from the stored production at the cost level and the overhead share generated in the account "Profit and loss".

There are times when professional reasoning is put to test by the legislative texts, excepting the fact that they are confusing, there are very also perishable. An example of this is that the revaluation of non-current assets which during a five years span was changed in terms of tax treatment and tax value revaluation reserve. For example, free revaluations made after 01/01/2004 that led to the recognition of a revaluation reserve were not recognized in the period 01.01.2004-31.12.2006, in the sense that the excess of depreciation resulted was considered non-deductible in determining taxable profit and wasn't taken into consideration when computing the fiscal value. Subsequently, between 01.01.2007 -30.04.2009 the situation was reversed in the sense that the revaluation reserve was recognized in depreciation and fiscal value of the assets.

After 30.04.2009, the revaluation reserve is again fiscally unrecognized, this time the provisions available between 01.01.2007-30.04.2009 on depreciation and tax value have been maintained but the taxation of the surplus depreciation from the afferent reserves revaluations made after the 31.12.2003 has become mandatory.

Following the changes of substance introduced into the Romanian accounting system, particularly by OMF 94/2001 and 306/2002, revaluations made after 01.01.2004 received the character of a free revaluation. The gap between accounting and fiscal legislation has made its presence at the level of fiscal recognition of differences from the revaluation of tangible assets. Initially, the revaluations required by law were necessary to reflect the growth of the fair value of fixed assets (generated, firstly by inflation and, later, by the development of the property). The economic crisis in Romania, whose effects are seen in the real estate sector, decreased in market value of land and buildings, leading to recognition of depreciation in the financial statements of entities. Once the first signs of harmonization of accounting to the European and international directives it can be seen that accounting regulations undertake also the negative revaluation differences, while the tax laws show a certain reluctance on the recognition of revaluation tax in general and of the negative differences in particular.

For those who understand "the game" of the legislator on revaluation, and for those who will understand later, the only noteworthy conclusion is that the revaluation free, subsequent to the legislative act H.G. 1553/2003, are not fiscally allowed, the short "fiscal relaxation from 01.01.2007 - 30.04.2009 is insignificant, for assets that usually have a life cycle of more than 30 years.

If in the regulating accounting matter, European and international referential alignment was initiated much earlier, the same thing can't be said about aligning the tax system in Romania. Harmonization of the tax system in Romania with European tax systems resulted in frequent changes of legal regulations in this area. Therefore, the non-synchronization effect of the accounting and tax regulation harmonization in Romania can be found in their difficult interpretation, with direct risks to both tax evasion and providing the "distorted" image of the accounting and fiscal performance.

#### References

1. from the companies practices;
2. Law 571/2004 regarding the Fiscal Code;
3. Law 82/1991, republished in June 2008;
4. Order no. 1752 from November 17<sup>th</sup>, 2005 for approving the accounting regulations consistent with European directives;