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**THE IMPORTANCE OF PROFESSIONAL JUDGMENT
IN BALANCE SHEET VALUATION**

**ZNACZENIE PROFESJONALNEGO OSĄDU
W WYCENIE BILANSOWEJ**

Summary of doctoral dissertation

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Justification for the topic selection

Business activity conducted by entities is becoming increasingly complex, with a large number of non-standard or difficult-to-measure events, as well as complex legal regulations. Economic situation is highly dynamic and the valuation of balance sheet items on the financial statements according to historical value does not always correctly reflect the reality, hence the need for valuation at fair value. Economic operators are obliged to report their results from individual reporting periods along with the projected future financial situation. The need to report projected figures forces entities to use estimates, often based on the judgement of the management or the person responsible for a given area of the entity's business activity. One of the requirements in contemporary accounting is to treat financial statements as a source of information for the purpose of decision-making, including decisions related to investments. The purpose of accounting and financial reporting is no longer just to provide records of past events and states, but also to be forward-looking and help the entities predict their future performance.

The need for information has been growing in recent years. Investors are expecting more and more relevant data, which includes not only figures alone, but also descriptive and non-financial information. In addition, the focus is not only on information concerning the past, but also data concerning the future of a given entity's business activity. In other words, financial statements should contain data that facilitates forecasting of the future of the economic entity. However, it should be noted that such data is based on estimates and judgement.

The reason for using professional judgement is also the increasing amount of intangible assets in companies, the value of which cannot, in many cases, be calculated other than by means of estimation and judgement.

Professional judgement represents a subjective view of those who make it. The quantification of a given economic event described unilaterally, from a subjective point of view, should be described in the financial statements, including – first and foremost - the assumptions which the person making the judgement adopted.

The judgement may concern numerous items in the financial statements, but mainly relates to assets. The exercise of professional judgement can be observed both in relation to intangible assets (including development costs), fixed assets, stocks and receivables. However, professional judgement is also applied in relation to liability items

on the balance sheet, such as provisions and accruals, which affect the costs of the current and future periods.

Another problematic issue is the nomenclature used to describe the nature of professional judgement. The terms "professional judgement" and "expert judgement" are often used interchangeably. There is no single standardised definition of professional judgement used in accounting. There are also no rules or algorithms for the valuation process with the use of professional judgement. The rules for its verification are not defined either. When relying on professional judgement, there is a risk of various mistakes, due to internal (e.g. haste, using mental shortcuts and mechanical thinking) or external reasons (e.g. time pressure, limited resources, legal regulations), especially those related to incorrect and inconsistent valuation of balance sheet items.

Professional judgement has not been officially recognised as a method, tool or technique for the valuation of balance sheet items. The literature on the subject offers only brief outline and explanation on the application of professional judgement.

The issue of professional judgement is in most cases presented from the perspective of financial audit in the National Auditing Standards. These standards offer guidance on conducting audits and verification of estimates included in balance sheet items, but do not address the issue of exercising professional judgement.

In the preparation of financial statements both in accordance with Polish Accounting Standards and International Accounting Standards, professional ¹judgement is exercised in a similar, if not identical way. In neither system is the judgement described in detail, but is made at the discretion of the person making it. It can, therefore, be assumed that professional judgement can serve as a tool that allows the management of a given entity to present a picture of the situation of that entity which is different than the actual one.

Another aspect that is still not resolved and described in the literature on the subject is the issue of the person(s) responsible for making the professional judgement. Can it be an individual or should it rather be a group of persons? The entity making the judgement

¹ The author of the dissertation uses the following terms in the sense specified below:

- Polish Accounting Standards (national accounting regulations) are the accounting principles arising from the Accounting Act, its implementing regulations and the National Accounting Standards (NAS),
- International Accounting Standards comprise International Accounting Standards and International Financial Reporting Standards approved by the European Union (IAS),
- American Accounting Standards are the accounting standards applicable in the United States of America (US GAAP),
- German Accounting Standards are the accounting standards applicable in Germany (HGB).

also affects its scope and quantification. Should it be a manager of the entity, an accountant, a person dealing with technical aspects of the company's business activity, or perhaps an external expert?

The need to exercise professional judgement to some extent stems from the wider application of International Accounting Standards, which are based on principles rather than rules. The sheer number and nature of economic events make it impossible to create a set of rules for each separate event. Even if an attempt was made to develop such a set of rules, it would still not exhaust the full range of possible events. This is, in a way, a downside of rules.

The use of professional judgement, its growing importance and popularity may in some cases lead to certain abuses. An example is influencing the outcome so that it is advantageous for the shareholders.

In view of the aforementioned dilemmas, the author believes it is important to undertake research related to the professional judgement in the process of valuation of balance sheet items of the financial statements and to develop principles for documenting and disclosing the algorithm for its application.

Research problem and aim of the dissertation

The research problem analysed in the dissertation concerns the importance of professional judgement applied by the management of an economic entity in the process of valuation of balance sheet items of the financial statements. In order to make the research problem more precise, the following research questions have been posed.

- What is professional judgement?
- Is professional judgement exercised correctly and what are the practical aspects of its current application?
- What is the relationship between professional judgement and the presented values of balance sheet items in the financial statements?
- Is it possible, and if so how, to improve the process of exercising and documenting professional judgement, as well as presenting the findings in the financial statements?

The aforementioned research problem is addressed in the following research hypothesis: The lack of uniform solutions for the application of professional judgement leads to inconsistent balance sheet valuation. The growing importance of professional judgement makes it an important problem in balance sheet valuation.

The main objective of the dissertation is to assess the importance of professional judgement in the process of balance sheet valuation, in order to develop an algorithm for exercising professional judgement and the principles of its documentation and reporting.

The aforementioned main objective was achieved by means of partial objectives, consisting in:

- presentation of the essence of valuation in accounting and discussion of the principles of financial statement preparation,
- discussion of the essence of professional judgement in accounting theory and the procedure for its implementation in the valuation of balance sheet items according to selected accounting standards (continental and American system) along with their comparison,
- evaluation of the application of professional judgement in financial statements prepared by Polish entrepreneurs and presentation of changes in this respect over the period of 9 years when the Accounting Act was in force (2011-2019),
- proposing a definition of "professional judgement" and an algorithm for its application.

The dissertation is devoted to a topic from the area of social sciences, and the discipline of economics and finance. The research area is financial accounting.

The dissertation addresses the issue of professional judgement exercised in the process of valuation of balance sheet items. It focuses on Polish enterprises listed on the Warsaw Stock Exchange or NewConnect ²market, as well as other entities preparing their financial statements in accordance with Polish Accounting Standards or International Accounting Standards.

The source materials used for the purpose of the research mainly include Polish and international publications on accounting and financial reporting, as well as applicable legal regulations in this area.

Research methods were selected so as to allow the achievement of both the main objective of the study and the partial objectives. In the theoretical part, in consideration related to the research area and the subject of research, the main research methods used included critical analysis of literature, critical-comparative analysis and the descriptive method. Analogy was also used when concepts with a general meaning were used with reference to accounting. Conclusions were made based on the synthesis

² The Warsaw Stock Exchange as the main market and NewConnect as the alternative trading system are operated by the Warsaw Stock Exchange S.A.

of the findings and deduction. In the empirical part, financial and comparative analysis were applied.

The empirical research was carried out in two stages on two different samples. The first stage involved an analysis of the financial statements of selected companies listed on the Stock Exchange and the NewConnect market. In the second stage, a survey was conducted in companies preparing their financial statements in accordance with the Accounting Act and International Accounting Standards.

The objective of both stages was to collect data on the relevance of professional judgement in the balance sheet valuation and answer the following questions:

- for which balance sheet items was professional judgement used?
- what is its relationship with the presented financial situation and assets of the entity?
- who was actually responsible for making professional judgement?

The time period, which the empirical research covered, coincides with the time when the regulations resulting from the Accounting Act have been in force in Poland, i.e. from 1994 to 2022.

Structure of the dissertation

The dissertation is divided into four chapters, preceded by an introduction and summarised in the conclusions. The dissertation was structured in a way to reflect the objectives of the research and the hypothesis.

The first chapter is devoted to the research area in question - financial accounting. The considerations presented refer to the topic of valuation in accounting theory and financial statements. The author analyses the differences between principles of preparing and presenting financial statements in accordance with Polish, international, American and German principles.

The first chapter corresponds to the first partial objective of the dissertation. Namely, it presents the essence of valuation in accounting (valuation paradigm) and discusses the principles of preparing financial statements.

The second chapter addresses the issue of professional judgement in financial accounting. It indicates the reasons for the growing importance of professional judgement in the process of balance sheet valuation and financial statement preparation, as well as discusses the problems and consequences related to it. An attempt was made to systematise the concepts related to professional judgement, and then the stages

of the application of professional judgement were presented. The final part of the chapter analyses solutions in the area of professional judgement in selected accounting standards.

The subsequent part of the dissertation is devoted to empirical research. The third chapter presents the purpose and methodology of the research, the selection of the research sample, the scope of research and the characteristics of the tools used. Focusing on Polish enterprises preparing financial statements, the research analyses professional judgement applied in the process of balance sheet valuation, reflected in financial statements.

The aim of the empirical research was to verify the hypothesis that the lack of uniform solutions in the application of professional judgement creates the risk of balance sheet valuation that is inconsistent with the actual situation.

The empirical research was carried out in two stages on two randomly selected samples. The first sample included companies listed on the Stock Exchange and on the NewConnect market. The second one consisted of entities preparing financial statements based in the Wielkopolskie Province. The empirical research allowed to collect data on financial statement items, with regard to which professional judgement was applied, as well as its relationship with the assets and financial situation of the entity presented. Data was also collected on the persons responsible for making professional judgement, as well as its place in the accounting policy (principles) of the examined entity. Comparison was also made between the accounting principles adopted by the entities in question with regard to the methodology of exercising professional judgement. At the end of the chapter, the results and conclusions of the empirical research are presented.

The fourth chapter assesses the application of professional judgement in balance sheet valuation by the companies in each of the samples and presents suggestions for improving the way it is exercised. The author also proposes his own definition of the term "professional judgement", as well as an algorithm to be followed when making professional judgement and presenting findings in financial statements. The mentioned algorithm may - in the author's opinion - increase reliability and comparability of financial statements. In addition, the author suggests guidelines for disclosures added as additional information in order to enable the reader to make their own assessment of the financial statements in terms of disclosed figures and plans concerning the entity (for example: in the case of an investor - in terms of making an investment, in the case of an employee - in terms of taking up or continuing employment with the entity).

The final part of the dissertation presents conclusions from the conducted empirical research and postulates for the academia and the legislator related to legal regulations concerning professional judgement.

In the preparation of the dissertation, domestic and foreign publications (scientific journals, articles, conference materials and Internet sources), as well as legal acts and standards in the field of accounting were used.

The dissertation is in accordance with the legal status as at 30 April 2022.

Empirical research results

The first stage of empirical research consisted in the analysis of publicly available financial statements of joint stock companies listed on the Stock Exchange and in the alternative trading system NewConnect. The research showed that professional judgement is an important tool, increasingly used to support balance sheet valuation. The results of the research showed that the higher the balance sheet total of the entity, the more important professional judgement is in the balance sheet valuation. The frequency of the use of judgement in balance sheet valuation showed a growing trend during the examined period, as evidenced by an increasing number of balance sheet items, as well as an increasing amount of descriptive information on the professional judgements applied in the financial statements.

The second stage of empirical research consisted in conducting a survey by means of a questionnaire sent to randomly selected entities from among joint-stock companies based in the Wielkopolskie Province. The findings from the second stage of empirical research can be summarised as follows:

- persons responsible for the preparation of financial statements were aware of the concept of professional judgement,
- the awareness of the importance of professional judgement in balance sheet valuation showed a growing trend in the analysed period,
- the persons responsible for making professional judgement were not always able to apply it in an appropriate way so that the results could be considered reliable or as accurate as possible,
- the respondents recognised the correlation between the entity's financial position and its financial result on the one hand, and the exercise of professional judgement on the other, which in their opinion is aimed primarily at improving the former,

- according to the respondents, professional judgement serves primarily to improve the financial result of the entities,
- professional judgement is mainly exercised by individuals from a given entity, but throughout the analysed period a change of this trend could be observed in favour of external entities.

In the questionnaire, the respondents made their recommendations with regard to the use of professional judgement in balance sheet valuation, the most important of which included:

- identification of persons exercising professional judgement in specific areas of the entity's business activity,
- using the knowledge and experience of co-workers in a particular area,
- relying on external, independent experts for professional judgement,
- holding discussions within teams, sharing knowledge,
- defining a methodology for making a given decision,
- creating models of judgements for a given situation (so-called good practices),
- consolidating the judgements made,
- passing information on to other people involved (communication).

The results of both stages of the empirical research corroborated that the lack of uniform solutions in the application of professional judgement may lead to balance sheet valuation that is inconsistent with the actual situation. The growing importance of professional judgement makes it an important problem in balance sheet valuation.

The last, fourth chapter is devoted to the author's own definition of the term "professional judgement" and the algorithm for making professional judgement.

The following definition was adopted: Professional judgement consists in the application of appropriate knowledge and acquired professional experience when making accounting decisions, especially in balance sheet valuation of a given entity, taking into account the conditions arising from the economic and legal circumstances of the entity in a specific place and time, and exercising the principle of prudence, as objectively as possible and in a properly documented way.

The author also proposes to improve the process of exercising and documenting professional judgement in the form of an algorithm. The essence of the algorithm can be described in terms of three main aspects:

- 1) knowledge and team - involving defining the purpose of the judgement, collecting information about the matter to be subject to judgement and forming a team responsible for dealing with the issue,
- 2) problem solving - involving exercising professional judgement by the team, also when a choice has to be made among existing alternative solutions,
- 3) documentation and communication - involving documenting the assumptions underlying the professional judgement made and communicating the decision made to the stakeholders.

Suggestions are also presented relating to the disclosure of information concerning the professional judgement made in relation to the balance sheet valuation in the financial statements. The chapter also includes examples of presented information concerning judgements made in the preparation of financial statements.

The dissertation also formulates recommendations and postulates with regard to financial reporting, which are important from the point of view of the recipients of financial information, and which result from the presented proposals. The author indicates the following challenges and postulates for further research:

- research on the essence of professional judgement,
- research on the importance of professional judgement in balance sheet valuation,
- further research on the algorithm of professional judgement application,
- continuation of research on the widespread application of professional judgement,
- research on the quality of professional judgement in accounting,
- research on ways to avoid problems when applying professional judgement,
- determination whether the presentation in the financial statements of multiple alternative judgements concerning the balance sheet valuation of a given item would meet the information requirements of the financial statement recipients,
- identification of accounting areas where professional judgement can be applied without distorting the balance sheet valuation, and areas where it cannot be applied along with reasons.

In addition, the author proposes the following postulates for the legislator in the scope of the balance sheet regulations:

- definition of the term "professional judgement",
- algorithm for exercising professional judgement in balance sheet valuation, including application of appropriate knowledge and experience of persons making the judgement,

- description in the introduction to the financial statements of the process of exercising professional judgement in balance sheet valuation along with the assumptions made,
- an explanatory note in the financial statements concerning the professional judgements applied by the entity and their impact on the presented figures,
- comprehensive explanation concerning the application, presentation and description of professional judgement in the National Accounting Standards.

The recommendations for further research and modifications in the balance sheet regulations were based on a synthesis of conclusions and a critical look at the existing methods of exercising professional judgement. The hypothesis put forward at the beginning of the dissertation concerning the lack of uniform solutions in the scope of application of professional judgement was corroborated.

To conclude, according to the author, the main cognitive results of the dissertation are:

- confirmation of the increasing role and importance of professional judgement as a tool supporting balance sheet valuation,
- identification of the correlation between knowledge, experience and financial reporting, as well as the impact of these factors on the image of the assets and financial situation of the entity presented in the financial statements,
- proposition of the author's own definition of the term "professional judgement",
- proposition of an algorithm for the application of professional judgement in balance sheet valuation, preceded by familiarisation with existing solutions, as well as adaptation of their stages to the current times and economic events,
- highlighting the need to stimulate discussion in the academic community on the subject of professional judgement,
- recommending postulates for further research in the field of application of professional judgement in balance sheet valuation,
- making recommendations for the legislator on issues related to the disclosure of the professional judgement used in the balance sheet valuation.

The process of exercising professional judgement, which is a tool supporting the balance sheet valuation, should involve persons responsible for the individual business areas of the entity, not only those responsible for accounting issues. Otherwise, the risk of making mistakes in the financial statements may be significantly higher.

Professional judgement is not a separate valuation method in accounting, but a tool used in the valuation of numerous areas and items of financial statements.

The author believes that the dissertation will contribute to academic discussions concerning the role of accounting in the process of making economic decisions, as well as will increase awareness of the importance of professional judgement in balance sheet valuation. The research and considerations presented are an attempt to answer important questions related to current problems and dilemmas of accounting. In the author's opinion, the proposed solutions concerning the exercise of professional judgement may become a stimulus for further scientific research, which should focus, in particular, on the improvement of the quality of professional judgement and its impact on the balance sheet valuation. The author sees opportunities as well as the need for further research into professional judgement and its application, especially concerning the issue of performing and verifying the correctness of professional judgement application in balance sheet valuation.