

**R** HIGHER SCHOOL OF ECONOMICS  
STATE UNIVERSITY  
NIZHNI NOVGOROD, RUSSIA

DEPARTMENT OF BUSINESS SCIENCES  
STATE UNIVERSITY  
FLORENCE, ITALY



NIKOLAY PETRUKHIN

SERGIO TERZANI

*Editors*

**HISTORY OF ACCOUNTING,  
BUSINESS ADMINISTRATION DOCTRINES  
AND DEVELOPMENT  
OF NEW METHODS OF MANAGEMENT  
IN ITALY AND IN RUSSIA**

*Scientific Series*

**// WORKSHOP  
Nizhni Novgorod, Russia  
16 - 17 September 2008**



**RIREA**



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# PROFESSIONAL JUDGEMENT AND ITS ROLE IN DEVELOPING AND ANALYZING COMPANY'S FINANCIAL POLICY

ALEXEY MAKAROV<sup>1</sup>

*Summary: 1. Financial Policy of a Firm: Some Definitions; 2. Professional Judgement (PJ) as a Ground for Taking Decisions Under Uncertainty; 3. The Role of PJ Nowadays: the Concept and Examples; 4. Conclusion.*

## 1. Financial Policy of a Firm: Some Definitions

Company's financial policy is considered as a part of economic policy of a firm and involves activities aimed to determine goals, conditions for developing financial and economic processes, tasks, criteria and methods of managing company's finances, tools for implementing and ways of evaluating management decisions at various stages of company's operation.

The aim of company's financial policy, in our opinion, is to optimize the management of company's financial resources, revenues, expenditures, profits (losses), and the value of business.

Developing company's financial policy involves choosing criteria, methods, tools, and decisions in managing financial and economic processes in accordance with their aims and conditions, as well as the evaluation of the impact of taken decisions on company's financial statement.

Making decisions appropriate for the conditions of company's operation is determined, to a large extent, not only by a correct choice and use of criteria of assessment and methods of analyses, but also by the quality of useful information. One of the key components of the system of providing information for financial management is company's financial re-

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## 2. Professional Judgement

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porting, and its preparation is based on the combination of interconnected principles and standards.

It is common knowledge that International Financial Reporting Standards (IFRS) are aimed at incorporating advanced international practice of preparing financial reporting.

**2. Professional Judgement (PJ) as a Ground for Taking Decisions Under Uncertainty**

IFRS use the notion of Professional Judgement (PJ) as a term. Its essence is that PJ is a point of view, a conclusion of an expert. It is the ground for taking decisions under the conditions of uncertainty. The sphere of taken decisions involves recognition and evaluation of the components of financial reporting. In those cases when the standards do not specify any clear rules for recognizing and evaluating some points the issue is solved on the basis of professional judgement, based on the prudence (conservatism) principle, as well as on the experience and skills of the person who is making the decision.

Uncertainty is a "bridge" connecting professional judgement and behavioral finances that research behavioral aspects of making decisions and preparing required information.

Russian and foreign authors point out that many models of financial management are built on the supposition that the world is perfect or ideal and investor's behavior is rational. Daniel Kahneman, who got the Noble prize in economics in 2002, sticks to the concept that rejects the fundamental economic postulate about the rational behavior of the market members. His research proved that people are not always driven by the idea of making profit. Sometimes because of different "whims" or "complexes" (e.g. fear to seem too gullible or failure to understand the problem fully) market members take decisions that are unreasonable from the economic point of view and unprofitable for them.

Elements of uncertainty and behavioral effects and abnormal reactions (decisions) connected with them are present at all the stages of developing and analyzing company's financial policy, whereas professional judgement is presented by IFRS as the ground for making decisions only in uncertain situations of recognizing and evaluating some components of financial reporting.



It should be noted that in those cases when the choice of the management decision (developing company's financial policy) is based on the data presented in the financial reporting, the bias effect of behavioral factors may be multiplied. This results in additional difficulties in making the decision that would lead to the expected financial and economic result. The process of company's financial management loses the necessary qualities of being a system and being aimed at achieving some particular result. In order to solve this problem it is expedient to disseminate professional judgement as a principle in the sphere of developing and analyzing company's financial policy.

### ***3. The Role of PJ Nowadays: the Concept and Examples***

Nowadays the role of professional judgement in developing and analyzing company's financial policy is significantly increasing because when a financial manager determines the requirements to the character, contents and depth of financial information he can have a direct or indirect influence on the behavior of those people who use this information, including existing and potential shareholders, investors, creditors, customers and suppliers of the firm. The nature of this influence is behavioral. Influencing the behavior of the user of the financial information the firm not only develops, but also implements its financial policy.

As an example let us consider an imaginary example of two firms, which have similar financial and economic indices of their activity at certain time horizon in the past and in the future. The annual financial report of the first company is presented in black and white with a limited number of comments,

Comments to the financial indices of the second company are presented as an exciting story about the activities of the company and contain elements of artistic decoration and design.

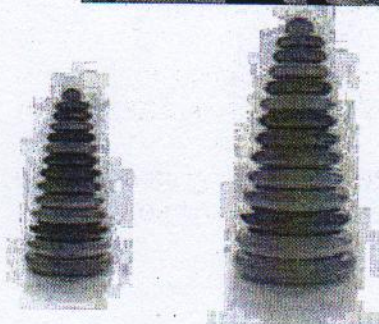
Notice, that subjective level of trust of a user is higher to that company, which presents financial information with creative comments.

Let us consider a real example. Some fragments of a Annual financial report of the "North-West Telecom" Joint Stock company is presented in figure 1. The question arises: Why does the serious telecommunication business use such obviously unserious elements of design?

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**FIGURE 1. The cover and design of diagrams of the "North-West Telecom" Joint Stock company**

In financial context this question can be reformulated in connection with the problem of evaluating intangible assets, namely company's business reputation. The answer is that without having the possibility to estimate the value of business reputation and to inform about it directly, but being sure of its existence, a financial manager has to send indirect "signals" that the company has positive business reputation. From our point of view the "North-West Telecom" JSC sends its users the following signals:

«Even children trust us»;



«Tables and diagrams are not more difficult than children toys»;  
«Children are our future and we have this future».

At present a firm rarely communicates with its stakeholders directly. Communicating with the professional community through financial reporting and other sources of information company's managers use a wide range of possibilities to draw in the minds of the decision-makers not only real, but also virtual image of the current financial statement and perspectives of the company. Trying to present the state of things in the best way is quite natural. The weight of the virtual component in the company's value increases. The virtual part of the image must be managed using specific behavioral tools.

#### 4. Conclusion

Disseminating professional judgement in the area of financial management, to our mind, if not to reduce, then to limit potential misuse and manipulations with financial information. Many factors prove that they exist, e.g. waves of bankruptcies, crisis phenomena on financial markets, etc. Professionals should find answers on such aspects of modern company's financial policy as:

1. What is the form of expressing professional judgement in the sphere of designing and analyzing company's financial policy?

In our view this opinion can be expressed in the form of a standard or a code, involving principles and rules of dealing with behavioral factors in developing financial policy and presenting financial information.

2. How to analyze the virtual component of financial relations?

It could be supposed that it's quantitative estimation expressed in the figures of additional financial profits or losses is not needed. However, it is this sphere where the most serious "battles" happen. Taking into consideration their results, it would be expedient to learn to evaluate not only qualitative, but also quantitative aspect of behavioral effects.

3. What determines the structure of behavioral factors and the character of their influence on company's financial indices?



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4. How to make sure that all members of the professional community stick to the generally accepted principles and rules (standards) in this area?

Corporate and Behavioral Finance future common development should find answers on these questions.

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The promoting of international relations in scientific research is one of the main sides of universities' role in the modern global scenario and the internationalization became a key word in the evolution of the Italian and Russian university systems, representing a new dimension of the academic activity. The growing internationalization of scientific research is a part of global processes regarding the development of knowledge-based society. International cooperation between institutions enhances the quality of higher research and education, moreover it creates new opportunities for growth at national level too.

The cooperation between the University of Florence and the Nizhni Novgorod branch of Higher School of Economics started in 2006. This fact has a great importance for both universities for different reasons: their recognized high academic level and research status, economic relations between Italy and Russia, significant presence of Italian business in Russia, in general, and in Nizhny Novgorod, in particular. The realization of the Scientific Agreement of Cooperation between these Universities is conducted by means of joint scientific research, seminars, lecturers' exchange, conferences and workshops organization.

This Agreement is especially important because the modern global research activity requires the unification of experience, interdisciplinary approaches to the study of various problems, broad application of quantitative analysis by mathematic and statistical methods and information technology systems for automatic data processing. The realization of all these aspects is possible only by means of international research groups creation (which combines the strength points of each participant) which represents one of the main aims of this cooperation.

In September of 2008 the II Workshop entitled "Management and Control Systems in European and Russian Companies" took place at Nizhni Novgorod. The present edition contains the selected reports of Russian and Italian Professors presented on it.





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