

The Role of Financial Statements in the Management of Reporting Companies

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Abstract:

The information used for decision making by the management of the economic entity derives mostly from the management accounting as the main source of information in the activities' administration and management. However, financial accounting, summarized by its annual accounts, is still providing information needed for managing relations with third parties, agreeing upon investment projects and financing resources.

Key words: accounting information, financial statements, economic decisions

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The construction of the accounting information is based on observation of an entity and its specific activity. Data processing in order to obtain information is made operating with specific accounting language and means so that they meet user needs. The accounting information system is part of the entity's overall system, specialized in the representation and economic measurement. It proposes a comprehensive modeling of the entity based on rules that ensure obtaining high quality

accounting information and not just a list of individual indicators.

Along with the role it plays in controlling the management of resources and its contribution to decision making by different users, accounting has become in recent years, a role of social adjustment.

Financial statements are a summary of information that characterize the patrimony elements of each company and represent the official management document, which must render a true, clear and complete image of the assets, financial position and results obtained. They include a system of indicators whose design is based on data from accounting, taken directly or previously processed.

Also, financial statements show the results of the entity's management, including the management of the resources entrusted to them. Those users, who wish to assess their management or responsibility, do so for economic decisions; such decisions may concern, for example, the option to keep or sell the investment in a company or the replacement or re-confirmation of leadership.

Economic decisions taken by users of financial statements require assessing the company's ability to generate cash or cash equivalents and the term and safety of their origination. Ultimately it depends, for example, on the ability of an economic entity / business to pay its employees and suppliers, to pay interest, to repay loans and to remunerate its owners. Users are able to assess the ability to generate cash or cash equivalent if they are offered information focused on the financial position, performance and changes in financial position of a company.

1. FINANCIAL DIAGNOSIS AND SUBSTANTIATION OF DECISIONS

Main source of information, accounting contributes to the preparation of decisions taken by the patrimonial entity and its partners. The industrial boom and the development of large companies, characterized by a separation between shareholder-owner and professional managers, led in the twentieth century to the increase of information needs of managers and investors. Other external partners, such as banks, customers, suppliers, public power, also need reliable information. Thus, the function of the traditional accounting has been supplemented by an internal and external *decisional utility*.

The information used for decision making by the management of the economic entity derives mostly from the management accounting as the main source of information in the activities' administration and management. However, financial accounting, summarized by its annual accounts, is still providing information needed for managing relations with third parties, agreeing upon investment projects and financing resources. In addition, SMEs that do not use a sophisticated management accounting, it becomes useful for information and decisions making. But the role of annual accounts as a means of information is to provide useful information for stock investors' decision making. This conception of the role of accounting "appeared in the United States before the World War II, with the development of large enterprises with large and wide ownership. Predominant in Anglo-Saxon countries, where enterprises are financed mainly by public capital, it spreads after fifty years in Europe along with the development of capital markets"¹.

The accounting information enables investors, actual or prospective shareholders to assess past, present and future events of a patrimonial entity, thus providing the basis for

¹ Esnault B, Hoarau Ch – „*Comptabilite financiere*”, Ed. PUF, Paris, 1994.

confirmation or denial of initial projections. An investor must be able to extract from published annual financial statements, elements enabling them to decide to increase, withdraw or decrease their investment.

Moreover, other business partners use the financial statements for decision-making. For example, banks use them to grant loans, public authorities - to grant or refuse a grant, suppliers - to accept certain terms of settlement etc. But the usefulness of information is much higher for the entity's management. While some accounting data can be used "gross" in decision making, many of them reveal their information value subsequently the process of analysis, which enables a financial diagnostic.

In general, the *financial diagnosis*² is designed to analyze the company's strengths and weaknesses. Therefore, it *relies* on economic, social, and financial accounting information. Most of the information used is financial and accounting data, taken from the review process.

Given the financial analysis is based on rules in order to properly assess the health of the company, a number of indicators allows the analyst to transform the assessment criteria into judgment, and to this end, the restrictions and fundamental financial goals arising from the financial theory should be considered.

The examination of economic reality requires a specific approach that integrates the classical view based on knowledge of causal relations and the internal laws of origination and evolution of phenomena, with the systemic-oriented study of their consistency in an evolving environment. Such an approach allows not only a correct assessment of the facts, but also it identifies vulnerabilities and opportunities for development, essential for substantiating management decisions.

² A. Deaconu – “*Diagnosticul și evaluarea întreprinderii*”, Ed. Intelcredo, Deva, 2000.

The *economic-financial diagnosis* is a tool that allows managers to issue qualitative and / or quantity judgments on a company's state, dynamic and an economic perspective, emphasizing its strengths and weaknesses, the ability to grow in a profitable manner.

The word "**diagnosis**" is of Greek origin and means "able to discern". It has the same meaning in economics and medicine. Regardless of field of use, diagnosis approach requires a prior complex analysis of the mechanism of formation and modification of specific phenomena.

The analysis of the company's activity and diagnosis is a set of concepts, techniques and tools for ensuring internal and external treatment of information for the formulation of relevant considerations relating to the economic-financial and strategic situation of the company and the level and quality of its performance, the risk in a very dynamic competitive environment.

The diagnosis is a tool of management³ which allows information prior setting objectives and information related to their achievement. Diagnosis does not mean to describe, but to identify key variables of the state and dynamics of phenomena, to study their interaction to determine the company's development objectives.

Thus, the diagnosis allows improving the consistency of important decisions to ensure the economic viability of the entity:

- Consistency between the company's tendencies and the elements of the competition environment;
- Consistency between objectives and goals;
- Consistency between the company's tactic actions, strategic orientation and the political-cultural system;

³ M. Niculescu – "*Diagnostic economic*", vol I, Ed. Economică, Bucharest, 2003.

Such an approach of diagnosis enforced in a transition economy could be compared with the classical approach of theorists and practitioners in this field. As J.P. Thibaut⁴ notices, the diagnosis could be defined as a sum of the following stages:

- To identify malfunctions and opportunities;
- To examine the facts (signs, indicators, etc.), to search for internal and external causes and to establish responsibilities;
- To set up the action schedule and the measures to redress or improve the outcomes;
- To enforce measures established;
- To control the goals' accomplishment.

However, we should mention that when companies under transition are involved, without disregarding the diagnosis' importance, attention should be paid to the implementation of its recommendations. Also, given that they face multiple and various incoherence, it is necessary to integrate the whole approach of the analysis in a systemic vision, in particular modeling.

The diagnosis' conclusions usually require relating to certain references. In economics, the results obtained from the analysis can be related to references whose meaning is often questionable, despite the improvement of statistical information on economic and financial behavior of firms, in general, and of those in need, in particular. For example, some companies may experience payment problems under a positive working capital, while others have a satisfactory solvency with a negative working capital. The problem of reporting bases arises especially in an economy in transition, where the accuracy of current and historical landmarks is challenged.

⁴ J.P. Thibaut - "*Le diagnostic de l'entreprise*", Ed. Sedifor, Paris, 1989.

Diagnosis is based on analysis' "results" without being confounded with it. a diagnosis implies assessments, judgments and, ultimately undertaking certain responsibilities in terms of reliable and accurate information; the substantiation of relevant value judgments depends on the extent to which the analyst masters economic theory, knows objective reality and their experience. The remark of N. Wiener, which noticed that: "in the absence of standard methods for exact computation, the role of the experts in assessing sociological, anthropological and business factors is so great that a novice who has not yet gained tremendous experience espoused by experts, is useless in this area"⁵, is fundamental, especially in a disturbed economic system, where future vision is no longer *based* on old models and solutions, but is subject to change requirements.

Diagnosis is constantly facing a real situation with a reference case. During stable periods, their recommendations are based, generally, on the reproduction of reference model, while in a disturbed it is forced to exceed the classic frame, to take account of new environmental characteristics, which make it impossible for usual solutions. In formulating the findings and recommendations of analysts, intuition plays a role as important as any deductive reasoning. Each entity is a particular case. Therefore, the diagnosis' approach must be sufficiently adaptable, flexible and open to the variety of situations.

A diagnosis is the preliminary of the strategic approach, which supplies reasoning essential for the confrontation of the management's goals with the internal and external reality. It is a tool to serve the will of change and progress that animates performing teams.

In *practice*, the prime source of information, particularly for financial analysts, is the social or consolidated annual

⁵ N. Wiener – "*Cibernetica*", Ed, Științifică, Bucharest, 1966.

accounts (financial statements). According to the Law of accounting, financial statements include: balance sheet, profit and loss account and annex.

International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) set up the framework to enrich and improve the quality of financial information. Accordingly, financial statements consist of: balance sheet, profit and loss account, statement of equity movement, treasury report, accounting policies and explanatory notes.

The Law of accounting Law (Law 82/1991) does not define explicitly the quality of accounting information. "Accounting as a major instrument of knowledge, management and control of property" (Law 82/1991, republished) is geared primarily to technical matters concerning the registration of various operations, processing and publication of information, valuation of property, control of economic operations.

Achieving the analysis' economic and financial goals and the conclusions' accuracy depend on its organization, both at the level of the analyst and the firm.

The diagnosis report is presented as a text prepared by (specialists) concerned, including equally figures and graphics.

Diagnosis is not an end in itself but a means of action to improve the results and the progress. Therefore, each proposal must be substantiated, to allow the answer to the following questions: What for? How? When? Where? How much?

The quality of analysis and recommendations is dependent on sources used, which is in some extent the "raw material" in the investigation of basic economic realities.

In practice the term "diagnosis" is often replaced by "**audit**". For the first time the notion of audit has been used by commissioners of accounts upon the verification of annual accounts. Gradually it has expanded, justified or not, in other areas. Considering the use of this concept as an effect of the fashion on the economic-financial language, we recommend its

appropriate use only for cases where judgments are made in relation to rules, laws, regulations, such as: accounting audit, quality audit etc. The restriction is even more obvious in an economy in transition, faced with a lack of landmarks or when their questionable veracity is at stake.

2. FINANCIAL SITUATIONS AND FORECASTS' SUBSTANTIATION

Financial diagnosis requires necessarily a size estimate. If the study of past evolution and current situation is an indispensable element of the act of management, it requires above all an assessment of expected developments in the near or distant future.

Accounting information is, as is known, retrospective in nature or, at best, up to date. "Of course, the time limitation of accounting is not as radical as it appears at first and the indications that it provides may be used for forecast exploits"⁶. For example, receivables recorded in the balance sheet will generate future earnings, but liabilities arising at some point will require further payments. As a result, information contained in the balance sheet will form the basis of forecasting for the short-term business solvency's study. However, the possibilities offered by exploiting accounting data in a forecast is not always sufficient. They must be supplemented by a clairvoyant perception of the company's financial prospects.

Activities currently carried out in a highly competitive environment compel economic entities to forecast in order to govern. Thus, prediction becomes an outstanding task of modern leadership and "*financial forecast* is perhaps the most important planning activity"⁷.

⁶ Cohen E. - , *Analyse financiere*., Ed. Economica, Paris, 1994.

⁷ Stancu I., - „*Finanțe, Teoria piețelor financiare, Finanțele întreprinderii, Analiza și gestiunea financiară*”, Ed. Economica, Bucharest, 1996.

Financial forecast is used by some specific means, company budgets which, unlike the balance sheet, are not for the general public, but they serve domestic guidance needs to achieve the objectives set by the company management, according to the realism of the forecast and management activities for its achievement, subsequent events will evolve more or less, on the lines drawn through budgets.

Because accounting information is generally the only information that is subject to a normalization and an obligation to publish, the general public - information user - has a tendency to believe that the information arising from the company merges with the production of **annual accounts and summary accounting documents - balance sheet and the result account**, but in fact, account information is generally only a minuscule part of the information produced by a business entity.

The essential information is the statistical information including data not necessarily linked by the principle of double entry. Most often, **long-term forecast information** is considered for statistics, given the difficulty of obtaining the overall forecast data to enable proper preparation of accounting documents.

Without being a historian, the analyst perusing the performance of economic entities is also interested in forecast data. As a general rule, all companies have a minimum of statistics forecast on short, medium or long term which allows the analyst to define strategy.

In general, the forecast demand of an economic entity is materialized in three forecasting documents and the financing plan⁸.

⁸ C.G. Dumitru- *"Dezvoltări și aprofundări privind valoarea informațională a bilanțului contabil"*, Ed. Universitară, Bucharest, 2005.

1. Long term plan. Is a document concerning the long terms statistics and which summarizes the company's consumption and resources for the following 5-10 years.

2. Medium term plan. The consumption and resources of the long term plan are detailed and provided upon the drafting of the medium term plan, which usually covers 3 to 5 years.

3. Forecast budgets and accounts. They are successive yearly documents, which resume and supplement the goals of the medium term plan, primary classifying them according to the company's various functions. Therefore, we have the following in term of income and expenses:

- **Sales budgets**, classified per main types of income or services;
- **Budgets for direct operation costs** (broken down as income) to outline the **margins of direct costs** regarding various income;
- **Budgets for indirect operation costs and general expenses.** The prior budgets are summarized in an account of forecast results which enables to establish the forecast result. Given, however, that forecasting is a random domain, the forecast result is generally attended by a **probability index**.

The forecast income and expenses are then translated into treasury terms and thus leading to the preparation of a **yearly forecast financing plan** aimed to record financial balance.

4. Financing plan. Once the forecast resources are established, a final financing plan is drafted.

This tool is attended by a **yearly forecast balance**.

All essential details of these plans are highlighted in a **dashboard**, the latter representing a statistical document of paramount importance.

Obviously the financial forecast should be accompanied by a budgetary control of achievements compared to plans, the

causes which generated deflection, in order to change the forecast, if reality requires or to alter the activity to bring the achievements close to forecasts.

Budgets include the company's main areas of activity. The budgets establish how resources and responsibilities are focused on each activity center. "The budget is then figure forecast of how resources and responsibilities are distributed to achieve business objectives cost-effectively"⁹.

In terms of content, the account of forecast results should list '*forecast results*', so by analogy with the annual income account, it shall include:

- Operation result;
- Financial results;
- Current result before tax;
- Extraordinary result;
- Net result.

Also the Decree states that the account of the forecast results should provide information on the value of the corresponding item during the previous year.

OECCA has supplemented these provisions by means of *Recommendation no. 17/4 December/1985*, that the accounts of forecast should to allow comparison with achievements.

The form of the account of forecast results. Companies are able to choose between two models of account of results:

- The **French model** with the classification of expenses by **nature** on the **overall production of the year**;
- The **Anglo-Saxon model** with the classification of expenses by **function** relative to **production sold during the year**.

Lack of legal regulations on the forecast result account enables companies to choose between the same options set out above.

⁹ Stancu I., - „*Finanțe, Teoria piețelor financiare, Finanțele întreprinderii, Analiza și gestiunea financiară*”, Ed. Economică, Bucharest, 1996.

The question is whether a company may, for example, to present historical result account according to the model per nature of expenses and results forecast account per destination. It seems that OECCA allows this dichotomy because it recommends specifically presenting a forecast result account per destinations, and not per nature, as the budgetary procedure does not allow a reclassification of expenses analogous to the classification adopted in the annual accounts.

The financing plan. *The Law on March 1984 in France on the prevention and friendly settlement of difficulties of companies and its implementing decree* requires companies to prepare a **yearly financing plan** no later than the end of the fourth month following the opening of the current year. The annual financing plan can be considered as a **forecast financing plan**. *Recommendation No. 17 of OECCA* insists that, although it does not contain the same degree of detail that the historical financing chart, the financing plan should allow comparison between the provision and achievements, hence the identity of structure between a financing plan and financing chart.

In what concerns the **balance sheet**, although by definition it is discussed and interpreted as a reflection and control model that consolidates information about an activity carried out activity, by its contents, it must provide information necessary to acknowledge the current situation and possible movements of values during a management period.

The provisional balance may be discussed under the form of a “**plan balance**”¹⁰ which includes decisions and objectives on the company’s assets and liabilities as balance markers, exhibiting the provisional balance of such patrimony elements on certain periods of time. Also, the provisional balance may be displayed under the form of a “**forecast**

¹⁰ M. Ristea – *“Bilanțul în gestiunea patrimoniului”*, Ed. Academiei României, Bucharest, 1989.

variant", which displays the balance of the patrimony elements at the beginning and the end of the forecast period.

The forecast results account and the forecast balance sheet are based on drafting the forecast treasury budget.

The **treasury budget** allows forecasting cash inflows and outflows in order to avoid the cessation of payments or the appearance of any unnecessary surpluses. Effectively, the operating revenue and expenses (excluding depreciation and provisions), financial operations and investments are related to immediate cashing or payments or within a certain period of time. If during certain periods there is a surplus of cash and it is important, there should be foreseen possibilities to place it. If, on the contrary, at other times there is a shortage of cash, additional resources will be sought to cover debts. The **treasury budget** is obtained projecting the company's earnings and future payments on different time intervals. For short period, monthly intervals shall be used given that there are considered the seasonal variations of the liquidity flows. When cash flows are unstable but predictable, it is necessary to prepare budgets on close periods of time. On the contrary, if the cash flow is relatively stable, quarterly budgets may be estimated or on longer periods, although practice shows that if the period is very long, the forecast is uncertain.

The **provisional result account** is a summary of revenue and expenditure estimates. It is the main instrument for both the forecast level and at the budget control level. The form of this account may be different from than the one regulated for the profit or loss account, depending on business needs.

In a forecast result account, revenues and expenses are generally divided into months or quarters, in order to enable budgetary control and cash budgeting. The forecast result account is a projection of future period results. As with the treasury budget, sales forecasting is central to program production and estimate production costs. We may start from

the assessment of each component of cost of goods sold. But it is very unlikely that a detailed analysis of purchases, salaries related to production, and general expenses will provide the most accurate forecasts. However, the cost of goods sold is often estimated started from past relationships between the cost of goods sold and sales.

In general, the commercial and administrative expenses will be estimated subsequently. As these costs are usually budgeted in advance, they estimates are relatively accurate. The next step is to evaluate other types of income and expenditure, obtaining the final net result before tax. Using the applied tax rate, the income tax is then calculated, which clearing it from the previous result, we obtain the net result after tax.

The forecast balance¹¹ is presented as a traditional balance sheet and allows providing the consequences of actions for the coming year on the economic situation and financial structure of the firm. Thus, it will allow such estimates: evolution of the movement flow, return on capital employed, etc. and it cannot be developed until after the forecast outcome and the cash budget are known.

3. FINANCIAL STATEMENTS AND CONTROL OF REPORTING ENTITIES

The management of financial and economic resources available to the patrimonial unit with maximum efficiency, maintaining the patrimony integrity, especially in conditions of market economy, requires organization and constant or regular exercise of control actions.

Monitoring is a management function that allows knowledge and improvement of the management of assets providing information to guide the work of production,

¹¹ C.G. Dumitru- " *Dezvoltări și aprofundări privind valoarea informațională a bilanțului contabil*", Ed. Universitară, Bucharest, 2005.

distribution and sales. Tool to measure the wealth originated by a company, accounting and yearly accounts provide the information necessary to determine the various financial claims, such as: dividends due to members, worker participation in profits, taxes, fees and similar payments required by the state. It also provides quality elements that allow controlling the compliance with the explicit or implicit contracts concluded between the company and its partners. Thus, accounting is financial-economic control, legal and social. The economic and financial control can be exercised both by people inside the unit, in which case, it takes the form of internal control, or people from outside, known as external control.

The internal control is designed to protect business interests by thorough knowledge of current management operations and setting up of management responsibilities relating to maintaining the integrity of patrimony. Although this form of control uses information contained in the annual accounts, most of the data used are extracted from current accounting of the company and, in particular, from the internal management accounting.

External control is exercised by persons outside the company targeting specific interests of authorities they represent: the State, other public authorities, investors, banks, etc. With some exceptions, most of the information used in the external control is contained in the annual accounts.

Therefore, annual accounts serve in particular monitoring and evaluation activities performed outside the unit, depending on the purpose of external control, it could be divided into: control of income distribution and control of tax determination of calculation.

3.1. Control of profit appropriation

Financial accounting provides for certain periods, as the annual accounts, information useful to the owners of a patrimony unit

on the financial situation at a certain period and result of operations conducted in a limited period. The latter, plus the profits of past periods that were not subject to division, represent the **basis for calculating the dividend** distributed to shareholders or partners. In addition to the right to dividends, shareholders profit for the value of capital invested in the firm, from the right to intervene in economic and social life of the company, particularly in the form of participation in decisions of the general assembly and the right to be informed on the entity's management.

In order to exercise these rights, accounting and annual accounts provide information that allows members to review the economic entity's business leaders. Thus, based on the elements contained in the annual accounts, associates and shareholders can assess the influence of investment and financing decisions on the financial situation and the result to be distributed. In order to protect shareholders' interests, there have been written laws relating to dividends' scrutiny, economic and financial situation of the company.

This guarantee of accuracy of the information contained in the annual accounts is achieved by controlling bodies appointed by the general assembly (audit committee) or self-employed accountants (accounting experts), who verify and certify the balance sheet. The verification and certification of annual accounts confirm if they give a true, clear and complete image of the patrimony, financial position and results of year. To this end, based on inspections during the year, and other elements necessary for reach correct conclusions on the certification of balances, a report is drafting showing mainly the following:

- If the balance sheet complies or not with the accounting ledgers;
- If the accounting ledgers are kept according to the regulations in force;

- If the regulations on the patrimony assessment and the other accounting rules and principles have been accordingly complied with.

By means of this report, auditors and independent accounting professionals can record the certification of the balance sheet, without reserves, certification with the reserves stipulated in the report or refuse the balance's certification based on solid grounds. The report is made communicated to the general assembly of shareholders and submitted for its approval. While the information contained in the annual accounts significantly meet the investors' needs of knowledge on the actual situation, it is extremely useful for the company employees. Thus, yearly accounts are used as a basis for negotiation by the union representatives related to higher salaries, equitable participation in the profit generated by the company, and as a means of monitoring compliance with contracts between company management and employee representatives.

3.2. Control of tax substantiation

Accounting data is used to establish multiple taxes, duties and similar payments due to state budget or other public authorities. All applicable business tax legislation is based on information provided by accounting, insofar as determining taxable income depends, first, on the correct determination of the result sheet. Then the latter is corrected to take account of differences arising between the specific accounting and tax rules, in addition, accounting provides data necessary to calculate VAT due to the budget, other taxes and duties in the charge of the company. Thus, data provided by the annual accounts represent a tool that favors the control of tax administration bodies for the timely payment of obligations the company has towards the state and to prevent tax evasion.

In order to achieve this objective, the legislature has intervened by multiple laws which establish the accounting

obligations of the taxpayers, the conditions for deductibility of expenses (by registering them in accounting ledgers) and the authority of the tax authorities to control the accounting of a company. Such control concerns to examine the accounting documents of an enterprise and to face the facts, to control statements made by the unit and possibly to determine additional taxes. Thus, the control of the taxes and duties concerns the enforcement of the economic agents' financial-fiscal discipline.

Therefore, the role of financial statements in the control of economic units is outstanding, being a support and a guarantee of the quality of the information contained, for decisions-makings both by domestic users and by those outside the unit.

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