

The Principle of Prudence and the Constituency of Provisions

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Abstract: Provisions are constituted for the purpose of complying with the principle of prudence. These are comprised into annual expenses until they are used. Their destination is to cover the expenses that prior or actual events make them possible. Indirectly, the provisions represent the equivalent of probable debts generating loss or expenses.

Keywords: provisions, legal obligation, implied obligation, prior event, uncertain value

In conformity with the principle of prudence we can encounter a constituency of provisions which cumulate until the moment of their use, the volume of sums included in yearly expenses. The object of provisions is well established, though the size and date of production are not precisely known.

They are determined by the end of financial exercise, time in which at the establishing of financial status of an entity should be considered all predictable obligations and potential loss which appeared in the completed exercise or on the running of a previous exercise. The acknowledged provision value must develop a better estimation to

the time of balance sheet of the necessary costs for erasing current obligation, generated by prior events. These provisions are accounted until the moment of their use in yearly expenses, having as a destination financing risks and losses (expenses) which prior or present events make possible (litigations, granted warranty to clients, reorganization, taxes etc.).

The International Accounting Standards debate, in great detail, the problems concerning defining, constructing and using provisions. Therefore, IAS 37 "Provisions, contingent liabilities and contingent assets" define provisions as a "liability of uncertain timing or amount".

A provision for being acknowledged in accountancy must fulfil the following conditions:

- a) the entity has the legal or implied obligation, generated by a prior event;
 - the obligation is legal, if it results from an explicit or implicit contract, from legislation or as an effect of the law;
 - the obligation is implied, if it results from an entity's activity of in the case in which through establishing a previous practice, through firm politics or through specifically enough declaration indicated to partners to assume several responsibilities and as a result induced the idea they will pay their responsibilities;
- b) the probability of out-resourcing which incorporates necessary economic sacrifice for paying a precise obligation;
- c) plausible estimation of obligation value;

Provisions' projection in accounting requires completing several steps:

- establishing and supplementing provisions, as an element of expenses:
- 6812 "Exploitation expenses concern - ing provisions = 151 "Provisions as a part of asset costs"
- 21 " Immobilisation accounts = 151 "Bodily provisions" (initially estimated costs with disassemble and moving of bodily immobilisations, as well as immobilisation position site restoration)

Supplementing (modification) of provisions is effected for completion of the financial exercise, when it should analyse and adjust to reflect a better current estimation.

Thus, if, for reaching obligations, a necessity of an out-resourcing is no longer probable, the provision is annulled.

2. the annulment and decreasing of provision by re-engaging at incomes:

- 151 "Provisions" = 7821 "Incomes from provisions"

3. use of provisions is made only with the purpose for its initial recognition, pursuing the adjustment of expenses due for the constituency of a provision with this precise purpose:

- acknowledge expenses turned liable:

6xx "Expenses accounts" = %	
(according to its nature)	3xx
	4xx
	5xx
	"Used resources accounts"

- re-engaged provisions:

- 151 "Provisions" = 7821 "Incomes from provisions"

4. repayment of provisions (art. 190 from OMFP 1752/2005) takes place when a part or all expenses connected with a provision will be repaid by a third party, repayment should be acknowledged only when its receive is a certainty. Repayment should be considered with a different asset.

The acknowledged values for repayment will not exceed the value of provision.

The repayment policy IAS 37, page 1759. A store applies a policy of money return to unsatisfied buyers, return of goods, though it is not a legislative obligation. The money return policy is very well known.

The event which obligates is the selling of goods; fact that generates an implicit obligation, for running a store induced to buyers the awaiting of reimbursement.

It is probable that a part of sold goods to be returned as an effect of reimbursement.

A provision is acknowledged to the best estimation of reimbursement costs.

Accounting regulations which are in conformity with European directives – OMFP 1752/2005 modified and revised in 2008 – stipulate (art. 34) that “provisions are destined to cover debts which nature is clearly defined and which to the time of balance sheet it is a probable or certain to exist, though uncertain on what concerns the values or specific time of their appearance.”

Provisions can not be used for adjusting asset value.

Subchapter 77 (completed with elements form IAS 37) strictly defines and delimitates provisions for being acknowledged.

A provision is a debt with uncertain liability and value.

For being acknowledged, a provision must fulfil the following terms:

- an entity has a current obligation generated by a previous event;
- it is probable that an out-resourcing to be necessary to respect a specific obligation;
- can be accomplished as a plausible estimation of obligation values.

A current obligation is developed as legal or implicit (IAS 37).

Provisions stand out from other debts (commercial credits or implied though unpaid expenses) through the uncertainty factor connected with liability or value of future expenses necessary to covering debt.

Provisions are not acknowledged by future exploitation losses.

Thus, it will be acknowledged as provisions, only the obligations generated by

previous events, independent by future action of entities (e.g. manner of running activity in the future). Such obligations are: fines or negative effects eliminating costs, caused to environment, punished by law, generating out-resourcing which incorporate economic benefits, regardless to future actions of entities. Analogous, an entity acknowledges a provision for closure costs of an oil plant by terms of remedy damages already instated. Unlike this particular situation, an entity can develop the necessity or have the intention, due to commercial pressures or legal claims, to effect expenses for being able to run its activity in a certain manner (e.g. installing smoke filters in a specific factory).

As an entity can avoid future expenses in activities by, for example, modifying the procedure of manufacturing, it does not have a due obligation to that future expense, therefore will not acknowledge any provision.

Elements for provision constituency are stipulated in art. 186, such as:

- litigations, fines and penalties, compensation, damages and other uncertain debts;
- expenses for service activity in war - rantee period and other expenses concerning the warrantee for clients;
- reorganization actions;
- pension and other similar obligations;
- taxes;
- other provisions.

Accounting registration of provisions is accomplished in several ways, considering their nature, the purpose or object for which they have been constituted.

Reorganization provisions can meet the following constituency situations:

- selling or ending activity of a part of business;
- closing
- modifying the structure of management, for example, eliminating a level in management;
- fundamental reorganization with an important effect in the nature and purpose of entity activity.

Reorganization provisions, in the case of a legal obligation, are constituted by following general terms of acknowledgement of legal provisions and stipulations.

Default obligation appears for an entity's provision constituency for reorganization if respected the following terms:

a) has an official detailed plan for reorganization, which stipulate at least:

- activity or the respective part of activity;
- main locations affected by reorganization plan;
- approximate number of employees which will be compensated for ending activity, distribution and their position;
- default expenses; and
- start time for implementing reorganization plan.

b) caused those affected expectations for reorganization accomplishment by beginning implementation of a plan or announcing its main characteristics to affected ones.

In the case in which and entity begins a reorganization plan or announces its main characteristics to affected ones solely after balance sheet, if reorganization is important and its representation may influence economic decisions of users based upon financial situations, an informative activity is necessary.

A provision for reorganization will include only direct costs generated by reorganization, such as:

- are generated necessarily by the process of reorganization; and
- are not connected with de continuous development of entity activity.

A reorganizational provision must not include costs as those connected by:

- requalification or permanent personnel replacement ;
- marketing ;
- investment in new systems and distribution networks.

Provisions for taxes for future owed state budget overdrafts are constituted in terms in which the overdrafts do not appear as debt in relation with the state.

Provisions must be strictly linked with risks and estimated expenses. For establishing the existence of a current obligation to due time of balance sheet, all available information must be considered.

The acknowledged value as provision must build the best estimation to due time of balance sheet of necessary costs to finalize current obligation.

The best estimation of necessary cost for finalizing current obligation is the overdraft which an enterprise will pay rationally for finalizing obligations to due time balance sheet.

Gain resulted by foreseen asset yielding must not be considered in evaluation of a provision.

Provisions are evaluated before determining taxes on profit, fiscal treatment stipulated by fiscal legislation.

For exemplifying, we present several operations recorded in accounting note of VAD S.A. society.

1. Commercial society VAD S.A. constitutes a provision with the value of 7300 lei, at the end of N-1 exercise, for litigation with a client, representing delivered and un-cashed goods. In N exercise the process is finalized with the cashed overdraft of 7000 lei.

- Distinct record of client in litigation:

4118 "Uncertain clients or clients in litigation" = 4111 "Clients"	7300
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- Provision constituency:

6812 "Exploitation expenses concerning provisions" = 1511 "Litigation provisions"	7300
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- Closure of expenses account at the end of financial exercise, with affecting the result:

7380/21 "Profit or losses" = 6812 "Exploitation expenses concerning provisions"	
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- Erasing debt to client, in exercise "N", according with judicial resolution.

% = 4118 "Uncertain clients or clients in litigation" <u>7300</u>	
5121 "Lei Bank Accounts"	7000
654 "Losses from debts and debtors"	300

Simultaneously, provision for litigations annulment without an object:

7300 1511 "Litigation provisions" = 7812 "Incomes for litigation provisions" 7300

- Closing expenses account

300 121 "Profit or loss" = 654 "Losses from debts and debtors"	
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2) Commercial society VAD S.A. delivered during the financial exercise "N -1" finite products with a values of 8000 lei with a warrantee period of a year. The medium rate for expenses with improvement of goods in warrantee period established in previous exercise was of 2%.

- Provision constituency $8000 \times 2\% = 1600$ lei

6821 "Exploitation expenses concerning provisions" 1521 "Provisions for client warrantee"	
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1600 lei

- Closure of expenses account at the end of "N - 1" exercise:

121 "Profit or loss" = 6812 "Exploitation expenses concerning provisions"	
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In warrantee period, as a consequence for received complaints from clients, it is estimated that the entity will be obligated in the financial exercise "N" to effectuate improvements of 2000 lei:

- Increasing provision in exercise "N" of 400 lei

6812 "Exploitation expenses concerning provisions" = 1512 "Provisions for client warrantee"	
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warrantee"

Buyer demanded improvements are made by a third commercial society, invoiced to producer, with a value of 2100 lei VAT 19%, in financial exercise "N":

- Invoice registration concerning expenses of improvement for the sum of 2100 lei and VAT of 19%

% = 401 "Suppliers"	<u>2399</u>
628 "Other expenses for third party service"	2100
4426 "Deductible VAT"	399
- Annulment of provision constituted for given warrantees of 2000 lei, without object:

1512 "Provisions for client warrantee" = 7812 "Provision incomes"	2000
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- Expenses account closure in financial exercise "N"

121 "Profit or loss" = %	2500
628 "Other expenses for third party service"	2100
6812 "Exploitation expenses concerning provisions"	400
- Closure of income account in financial exercise "N":

7812 "Provision income" = 121 "Profit and loss"	400
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3) VAD Commercial society decides in December exercise "N – 1" to close section no °3. It approved a detailed plan concerning activity restraint and effecting compensatory payments of 250.000 lei to reorganization affected personnel.

6812 "Exploitation expenses concerning provisions" = 1514 "Reorganization provisions" 250.000

- Closing expenses account for "N – 1" exercise:

121 "Profit or loss" = 6812 "Exploitation expenses concerning provisions"	250.000
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- Effecting compensatory payment in exercise "N"

6588 "Other exploitation expenses" = 4281 "Other duties concerning personnel"	250.000
4281 "Other duties concerning personnel" = 5121 "Lei bank account"	250.000
- Provision annulment at due time of expenses effecting.

1514 "Reorganization provisions" = 7812 "Provision incomes"	250.000
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- Closing expenses account:

121 "Profit or loss" = 6588 "Other exploitation expenses"	250.000
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- Closing income account

7821 "Provision incomes" = 121 "Profit or loss"	250.000
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VAD society established to pay pension (benefits) at the end of service of 2% form the salary for each year of service. The salary in first year of employment is of 20.000 lei and assumes an increase of 5 % (composed) in each year. The rate of actualization is of 10 % per year.

The obligation for pension towards employee with a 5 year contract and sums constituted which will modify provisions are as following:

- Yearly salary at the end of period can be estimated at $20.000 \times (1 + 5\%)^4 = 24.3120$ lei
- Each year of activity gives the right to an instalment of $24.310 \times 2\% = 486$ lei on retirement due.

According to Om 237/2007 which states that "the values of pension provisions are established by field specialists".

Specialists calculated the final obligations as seen in the table below:

Year	1	2	3	4	5
Final obligation	332 lei	730 lei	1205 lei	1767 lei	2430 lei

Accountancy recordings:

- First year it is constituted a provision for payment final obligation of 332 lei.

6812 "Exploitation expenses concerning provisions" = 1515 "Pension provisions and similar obligations" 332

- Second year increase of provision of 398 lei (730 – 332)
6812 “Exploitation expenses concerning provisions” = 1515 “Pension provisions and similar obligations” 398
 - Third year increase of provision of 475 lei (1205 – 730)
6812 “Exploitation expenses concerning provisions” = 1515 “Pension provisions and similar obligations” 475
 - Fourth year increase of provision of 562 (1767 – 1205)
6812 “Exploitation expenses concerning provisions” = 1515 “Pension provisions and similar obligations” 562
 - Fifth year increase of provision of 663 lei (2430 – 1767)
6812 “Exploitation expenses concerning provisions” = 1515 “Pension provisions and similar obligations” 663
 - Record of payment obligations for pension
6458 “Other expenses concerning insurance and social protection” = 4281 “Other duties concerning personnel” 2430
 - Payment of pension fund
4281 “Other duties concerning personnel” = 5121 “Lei bank account” 2430
 - Annulment of constituted provision
1515 “Pension provisions and similar obligations” = 7812 “Provision incomes” 2430
 - Closing expenses account
121 “Profit and loss” = 6588 “Other exploitation expenses 250.000
 - Closing income account
7812 “Provision incomes” = 121 “Profit and loss” 250.000
- Commercial society VAD constitutes in N – 1 exercise a provision of 7800 lei for probable penalties established following the un-payment in due time of several taxes which would be paid in exercise “N”.
- Provision constituency in financial exercise “N – 1” of 7800 lei
6812 “Exploitation expenses concerning provisions” = 1516 “Provisions for taxes” 7800
 - Closure of expenses account in financial exercise “N – 1”
121 “Profit or loss” = 6812 “Exploitation expenses concerning provisions” 7800
- In exercise “N”, the society acquits penalties of 7700 lei
- Penalty payment
6581 “Compensation, fines” = 5121 “Lei bank accounts” 7700
 - Provision annulment
1516 “Provision for taxes” = 7812 “Provision incomes” 7800
 - Closure of expenses account:
121 “Profit or loss” = 6581 “Compensation, fines” 7700
 - Closure of income account
7812 “Provision incomes” = 121 “Profit or loss” 7800
- Therefore, at the end of exercise could be established in balance sheet only accomplished benefits.

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