

THE ACCOUNTING AND FISCAL TREATMENT OF PROVISIONS

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Abstract. *This paper treats the issue of establishment by entities of litigation provisions, customer guarantees, restructuring, taxes or other provisions. The reason we have chosen as a subject of debate the constitution of provisions, results in the importance that they have in the activity of the economic entity.*

The purpose of our research is to demonstrate, from the perspective of practice, the importance of calculating and recording in the accounting of provisions under national and international law. The provisioning should take into account the principle of prudence, according to which "depreciation is recognized, regardless of whether the result of the financial year is loss or profit. Registration of impairment adjustments or loss of value is performed on the expense account regardless of their impact on the profit and loss account".

Keywords: *provisions, performance, economic entity, national and international accounting rules*

JEL: *M 41, M 48*

Introduction

"This paper deals with the issue of *constituting the provision for litigation and guarantees* by entities, granted to customers. The reason for which I have chosen as a subject of discussion, the *provisions constitution* lies on their importance within the activity of the economic entity."

"The purpose of my research is to demonstrate, from the practice perspective, the importance of calculating and recording provisions in accounting under national and international law. The *provisions constitution* should take into account the principle of prudence, according to which *depreciation is recognized, regardless of whether the result of the financial year is loss or profit. The recording of depreciation adjustments or loss of value is made on the expense accounts, regardless their impact on the profit and loss account.*"

Through this study I will show the impact of the provisions for litigation and guarantees granted to customers on the accounting profit, on the related tax and, as well, the fiscal implications which occur in this situation. This paper studies the necessity and the importance of provisions for an economic entity. The research method is of accounting nature using accounting-specific instruments such as the account, financial statements (balance sheet, profit and loss account and their annexes).

1. Accounting regulations regarding the evaluation and recognition of provisions

1.1.1 Provisions – definitions and structures

Provisions for risks and expenses are sources of the economic enterprise constituted at the end of a calendar year in order to avoid the possible loss generated by the occurrence of some phenomena and to avoid the risks of the next period, such as litigation with other competing commercial companies, guarantees given to its clients, decommissioning of immobilizations, restructuring of the staff employed within that enterprise.

These provisions are based on expenses, causing a profit diminution and a decrease of the corresponding profit tax. Following, in the near future, the occurrence of the risk phenomenon, the provision remains without object and, therefore, it will be canceled on the income side.

Provisions for litigation will be constituted by the enterprise only if it is in litigation with a commercial company or even with several, to prevent the risk of losing the process or processes in which it engages.

Guarantees provisions granted to the customers of an enterprise are constituted when the company sells goods, goods for which is stipulated within the contract, invoice, warranty period. Thus, to prevent a risk from those customers claiming defective products during the period in which the right to guarantee is exercised, the retouching or the defects reparation shall be supported by the

commercial company that sold the respective goods, therefore the provision remaining without object shall be canceled.

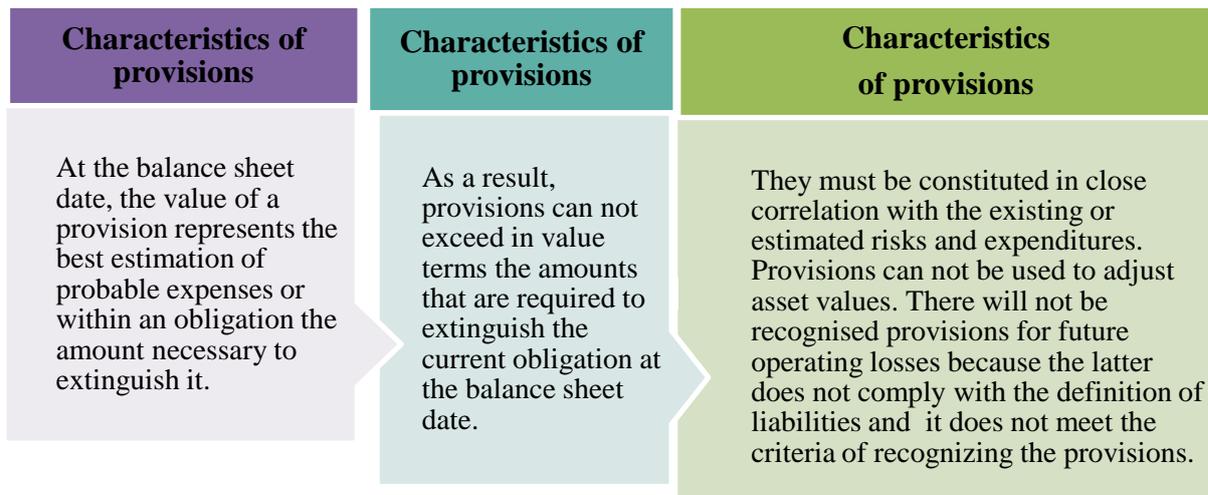


Figure no. 1. Characteristics of provisions

Source: Personal elaboration based on OMFP 1802/2014, art. 371 – 387

In conclusion, the provision for risk and expenses helps the enterprise to overcome a risk situation by paying lower profit tax in the year preceding the risk.

According the OMFP 1802/2014 (art. 374, pragraf 1), we can say that provision is a liability which has an uncertainty chargeability or value and which will be recognized when an economic enterprise has an obligation in the current period, "generated by past events, events previous to the date on which the obligation occurs, and it is possible that a resources output is necessary whereas it can meet that obligation; it can be estimated a credible value of the obligation. "If these above conditions are not fulfilled, we cannot recognize a provision".

1.2. Accounting regulations for the provisions fiscality

According to the fiscal code in force in 2017, any taxpayer has the right to deduct the provisions. The deductible provisions are:

- Provisions for good execution guarantees granted to customers;
- Provisions constituted within a limit of 20% starting with 1st January 2004, 25% starting with 1st January 2005, 30% starting with 1st January 2006, of the value of receivables on customers, registered by taxpayers;
- Provisions that are constituted within a limit of 100% of the value of receivables on customers, registered by taxpayers, if they meet certain conditions;
- The specific provisions, constituted according to the laws of organization and functioning, by the credit institutions, the non-banking financial institutions registered in the General Register held by the National Bank of Romania, as well as the specific provisions constituted by other similar legal entities (Fiscal Code, Article 46, Paragraph 1);

2. The effects of constituting provisions on the performance of SC Energo Instal SRL

2.1. Presentation of the company

The entity SC Energo Instal SRL was established in 2003 in Suceava County, having the legal form of a limited liability company.

It started its activity on 19.08.2003, dealing both with the sale of materials and equipment for sanitary and thermic installations, air conditioning, ventilation, heating plants, automation systems, water and sewage networks, as well as electrical installations. The company's CAEN code is 4321.

The company has its headquarter in Suceava, on Calea Unirii Street, no. 31 C, and from 2011 has opened a working point on Eroilor Street no.66, also in Suceava.

In order to not harm the image of the entity, we have changed the name to SC Energo Instal SRL.

2.2. The impact of provisions on the result of the entity

2.2.1. Provisions for litigation

"Provisions for litigation shall be established for litigation under legal proceedings, the provision amount representing the amount of the litigation object to which other incidental expenses shall be added, such as court fees and technical expertise (Cernușcă, 2010, p.69).

Their establishment is required by the need to accurately reflect the financial position and the performance of the enterprise (Mates et al, 2010, pp. 79-80).

The current legislation warns us that the expenses with the provision establishment are not deductible, excepting the following:

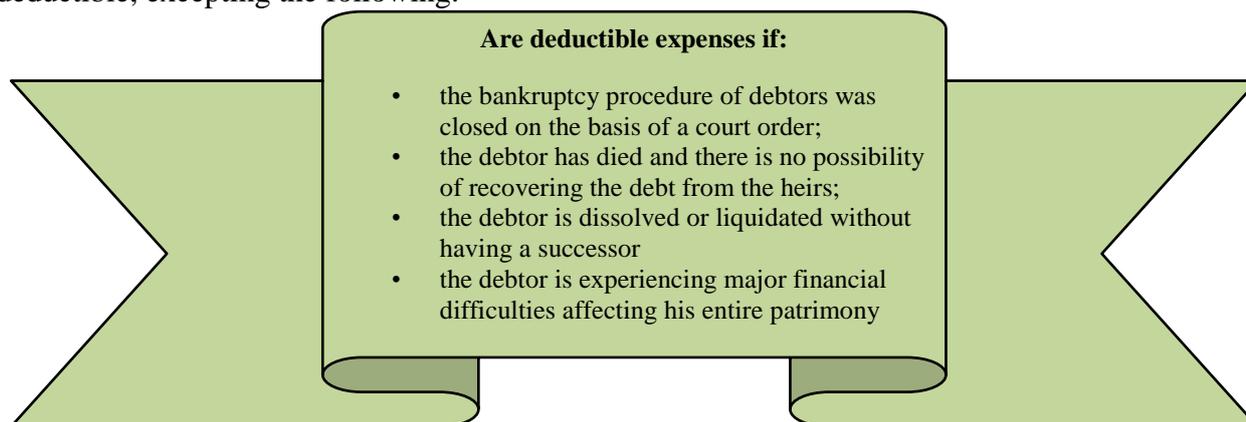


Figure no. 2 Deductibility of the provisions for litigation

Source: Personal elaboration

I will show the impact of establishing provisions for litigation on the company's financial result through the following example:

Example: In the financial exercise 2014, the company delivered materials for an electrical installation to SC United Media SRL, with a total value of 1.488 RON, VAT included. In 2015 Energo enters into litigation with the client and at the end of the financial year it is decided to set up/constitute a provision of 1.488 lei. Within the next year, the litigation is resolved and the provision is canceled.

a) Is recorded the sale of goods to SC United Media SRL in 2014:

4111	= %	1.488
707	1.200	
4427	288	

b) Is recorded the passing of 1488 to uncertain customers in the year 2015:

4118	= 4111	1.488
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c) Is recorded the establishment of provision at the end of the year 2015:

6812	= 1511	1.488
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d) Is recorded the debt collection as a result of litigation settlement in the year 2016:

5121	= 4118	1.488
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e) Is recorded the cancellation of provision at the end of the year 2016:

1511	= 7812	1.488
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Considering that this is not one of the four situations presented in Figure no. 2, the expense on which the provision was constituted is a non-deductible expense. In this case, the profit tax will not be diminished, and the establishment of provision does not intervene in the modification of the amounts paid to the state budget.

I will show below the changes that take place in the entity's balance sheet and within the profit and loss account after constituting the provision for this litigation.

Table no. 1 presents the balance sheet items of the analyzed entity, showing, in comparison, the situation in which the company has no provisions and the situation in which it is decided to constitute provisions.

Table no. 1 Extract from the balance sheet of SC Energo Sistem SRL entity

Element name	Values related to the year 2015	
	The situation in which we do not constitute provisions	The situation in which we constitute provisions
A. Fixed assets	1.233.235	1.233.235
B. Current assets	5.899.187	5.899.187
C. Accrued expenses	32.900	32.900
D. Short term debts	6.371.922	6.371.922
E. Net current assets	-737.732	-737.732
F. Assets minus current liabilities	495.503	495.503
G. Log-term debts	-	-
H. Provisions	-	1.488
I. Incomes in advance	297.897	297.897
J. Capital and reserves	495.503	494.157
I. Capital	184.000	184.000
II. Revaluation reserves	13.221	13.221
III. Reserves	25.881	25.881
IV. Profit	272.401	270.913

Source: Personal elaboration based on the data of SC Energo Sistem SRL entity

Table no. 2 shows the comparative situation regarding the constituting of provisions for litigation and the changes that appear in the profit and loss account.

Table no. 2 Extract from the profit and loss account of SC Energo Sistem SRL entity

Element name	Values related to the year 2015	
	The situation in which we do not constitute provisions	The situation in which we constitute provisions
1. Turnover	4.670.316	4.670.316
2. Operating incomes	5.221.906	5.221.906
3. Operating expenses	4.899.312	4.900.800
4. Operating profit	322.594	321.106
5. Financial incomes	3.586	3.586
6. Financial expenses	5.496	5.496
7. Financial profit	-1910	-1910
8. Total incomes	5.225.492	5.225.492
9. Total expenses	4.904.808	4.906.296
10. Gross profit	320.684	319.196
11. Profit tax	48.283	48.283
12. Net profit	272.401	270.913

Source: Personal elaboration based on the data of SC Energo Sistem SRL entity

We observe the changes occurred in the financial statements, changes in the balance sheet items and in the profit and loss account that are imprinted on the entity's image. Establishing provisions for this litigation determines the amount of 1.488 RON in provisions, thus increasing the *H item - Provision* in the balance sheet.

Within the balance sheet items, the entity's *own equity* changes due to a decrease in profits to 270.913 RON from 272.401, as it was before this provision was recorded. This decrease occurred with the increase in operating expenses, reducing the profit but not the profit tax.

2.2.2. Provisions for guarantees

"Provisions for guarantees provided to customers are intended to cover risks arising from sales contracts whereby the enterprise undertakes the commitment to replace or repair the defective products during the guarantee period." (Cernușcă, 2010, p. 70).

"They have as object the delivered goods, the works performed and the services rendered for which guarantees are given in the following periods, at the level of the quotas (%) stipulated within the contracts." (Mateș, 2010, p.80).

Guarantees to cover repair costs generated due to the manufacturing defects are granted to goods which are the subject to such risks, particularly to durable goods: auto and electronics. Guarantees are also provided for the works executed, such as: construction of buildings with different destinations, construction of bridges, roads, highways (Vișan, 2011, p.21).

Registration to incomes of these provisions shall be made to the extent to which the remediation expenses are incurred or the expiry period of the guarantee entered in the contract." (Grosu, Hlaciuc, 2015-2016, course notes).

Example: In the financial exercise 2014, Energo Instal sells electrical installation materials accompanied by guarantee certificates in an amount of 50.000 RON, and repairs expenses were worth to 2.000 RON.

Considering the situation of the previous years, during the warranty period, there may be some situations of returning the products delivered for repair or replacement (Cernușcă, 2012, p. 135).

In 2015, were sold materials in an amount of 70.000 RON, and repair expenses were in the amount of 2.375 RON. In order to be able to calculate the amount of the provisions that will be recorded in accounting, we go through the following steps:

- a) Is being determined the average share realized in the financial year 2014:

$$C_m = \frac{Chr}{V} = \frac{2.000 * 100}{50.000} = 4\%$$

Where: C_m = the average share realized in the previous financial year;

Chr = expenses made with remediation within the guarantee;

V = incomes realized from the delivered goods, the works performed and the services rendered for which guarantees are given according to the contracts concluded (Cernușcă, 2006, p. 228);

- b) Are being determined the expenses with provisions:

$$C_p = V * C_c = 4\% * 70.000 = 2.800 \text{ RON,}$$

Where: C_p = expenses with provisions;

V = incomes registered within the reporting period of the delivered goods, the works performed and the services;

$C_c = C_m$ = the share provided in the contracts with the clients (Cernușcă, 2004, pp. 221);

Recording in accounting:

- a) Is recorded the provision for guarantees granted to clients (2015):

$$6812 = 1512 \quad 2.800$$

- b) Are recorded the repairs expenses of the products that have certificate of guarantee, made within another specialized firm (2016):

$$\begin{array}{r} \% = 401 \quad 2.850 \\ 628 \quad 2.375 \\ 4426 \quad 475 \end{array}$$

- c) Is recorded the debt payment to the supplier who performed the repairs (2016):

$$401 = 5121 \quad 2.850$$

- d) Is recorded the cancellation of provision remained without object (2016):

$$1512 = 7812 \quad 2.800$$

In the following tables I will outline the changes that occur at the entity level by making provision for guarantees, and whether the impact of these provisions on the economic situation is

positive or negative. According to the legal norms, the expenses on the provisions for guarantees of good execution are considered deductible in the calculation of the taxable profit (www.fiscalitatea.ro).

Table no. 3 Extract from the balance sheet of the SC Energo Instal SRL entity

Element name	Values related to the year 2015	
	The situation in which we do not constitute provisions	The situation in which we do not constitute provisions
A. Fixed assets	1.233.235	1.233.235
B. Current assets	5.899.187	5.899.187
C. Accrued expenses	32.900	32.900
D. Short term debts	6.371.922	6.371.474
E. Net current assets	-737.732	-737.284
F. Assets minus current liabilities	495.503	495.951
G. Log-term debts	-	-
H. Provisions	-	2.800
I. Incomes in advance	297.897	297.897
J. Capital and reserves	495.503	493.151
I. Capital	184.000	184.000
II. Revaluation reserves	13.221	13.221
III. Reserves	25.881	25.881
IV. Profit	272.401	270.049

Source: Personal elaboration based on the data of SC Energo Sistem SRL entity

Table no. 4 Extract from the profit and loss account of SC Energo Sistem SRL entity

Element name	Values related to the year 2015	
	The situation in which we do not constitute provisions	The situation in which we do not constitute provisions
1. Turnover	4.670.316	4.670.316
2. Operating incomes	5.221.906	5.221.906
3. Operating expenses	4.899.312	4.902.112
4. Operating profit	322.594	319.794
5. Financial incomes	3.586	3.586
6. Financial expenses	5.496	5.496
7. Financial profit	-1910	-1910
8. Total incomes	5.225.492	5.225.492
9. Total expenses	4.904.808	4.907.608
10. Gross profit	320.684	317.884
11. Profit tax	48.283	47.835
12. Net profit	272.401	270.049

Source: Personal elaboration based on the data of SC Energo Sistem SRL entity

As a result of constituting the provisions, they appear in the balance sheet at *H item - Provisions* in amount of 2.800 RON. At the level of the *own equity*, the decrease is registered, the net profit being reduced by 2.352 RON. The short-term debts increase by 448 RON, and they will be paid at the beginning of the next financial year.

From the profit and loss account, we observe an increase in operating expenses, so the operating profit decreases by the amount of 2.800 RON. Taking into account the fact that the expenses on the provisions are tax deductible, they contribute to the decrease of the profit tax by 448 RON. This situation is favorable for the entity because it will pay less tax to the state budget than if it had decided that provision should not constituted.

Conclusions

Behind processing the information from the accounting, there are some situations in which we have to make decisions that may or may not affect the image of the entity.

If we analyze what happens in practice, many accountants actually refuse to get involved with these operations because they focus first on taxation and then on the accounting side. Considering that most of the provisions are not tax deductible, not too many people get involved to record them, because from their point of view this means wasting time.

From my point of view, things should first be treated in accounting terms, and then fiscal, although accounting was, is and will remain the main provider of tax information. Accounting and taxation are complementary, but many decisions are made taking into account the tax side. For this reason, if we look over the financial statements of other entities, no provision will be made. And if they are, for sure they will be provisions for guarantees because these are tax deductible.

In conclusion, as a result of the recording of provisions, they are not constituting real financial flows, the entities juggle with them only to achieve a temporary tax saving.

If we want to answer to the question, "*Why to constitute these provisions?*", The answer is as simple as possible, *for companies to cover a risk margin that may arise in different situations and they may face during the period of activity and whether or not related to the object of activity.*

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