PROVISIONS AND VALUE ADJUSTMENTS. ACCOUNTING, TAX AND FINANCIAL ISSUES

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Abstract:
Nowadays, more than ever before, it is necessary that an economic entity, either a trade company or a credit institution, should make profit. Profit ensures the entity's future development and also renders a meaning to the respective business. At the same time, any economic entity wants financial comfort that can also be achieved by small amounts paid as taxes and fees. Additionally, annual financial statements are meant to reflect a true and fair view of the financial status and of the financial performance achieved. Among true and fair view, accounting principles and tax issues a number of differences may occur which can complicate the life of an enterprise. In terms of accounting and tax issues, the most frequent in the core of such differences are provisions and value adjustments. The paper aims at capturing some financial, accounting and tax issues of provisions and value adjustments.

Key Words: *provisions, value adjustments, tax, deductibility, self-financing ability*

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1. Introduction

The ratio between accounting and taxation must be regarded both from the perspective of some effects produced by this ratio, and of the influence degree on the objectives of the two fields.

At international level, the concept of true and fair view of the information included in financial statements does not have the same degree of consideration, it is treated differently from one country to another, depending on the connection or disconnection ratio of accounting versus taxation. When accounting information is aimed primarily at ensuring the interests of investors, a principle specific to the Anglo-Saxon accounting, it is about accounting disconnected from taxation, where not all the elements making up the tax calculation basis are provided by accounting information. If the information provided by accounting is intended to ensure fiscal interest, then it is accounting connected to taxation, which may cause the annual financial statements to provide unreal enterprise activity.

3. Treatment of Provisions

IAS 37 "Provisions, contingent liabilities and contingent assets" defines a provision as a liability with uncertain exigibility or value.

According to the legislation in our country (OPFM 1802/2014 for approving accounting regulations regarding annual individual and consolidated financial statements), provisions are meant to cover the liabilities whose nature is clearly defined and which at the balance sheet time are likely to exist or are to exist, but are uncertain in terms of value or the date they will occur. On the balance sheet date, the amount of a provision is the best estimate of the probable costs or, in the event of a liability, of the amount required to settle it. As a result, provisions may not exceed in value terms the amounts required to settle the current obligation on the balance sheet date. Provisions must be strictly correlated with estimated risks and expenditures.

A provision is a liability of uncertain exigibility or amount. A provision shall be recognized only when:

- an entity has a present obligation generated by a previous event;
- it is probable that an outflow of resources should be required to settle the respective obligation; and
- a reliable estimate can be made of the obligation amount.

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If these conditions are not met, a provision shall not be recognized. Provisions can be distinguished from other liabilities such as debts from commercial loans or expenses incurred but not paid due to the uncertainty factor related to the exigibility or amount of future expenses required to settle a liability.

Provisions are a sub-class of liabilities. Liabilities are defined in the *Framework for the Preparation and Presentation of Financial Statements* as current obligations of an entity arising from past events, whose settlement is expected to result in an outflow of resources embodied in economic benefits of the entity.

An implicit liability is an obligation arising from the actions of an entity if:

a) via setting an earlier practice, via a company's written policy or via a sufficiently specific statement, the entity has shown its partners that it assumes certain responsibilities; and

b) as a result, the entity has induced the idea to its partners that it shall fulfil those responsibilities.

Uncertainty is a key feature of a provision. *IAS 37* identifies four types of liabilities:

a) liabilities from commercial loans;

Debts which mean obligations to pay for the goods or services that have been received from/or rendered to suppliers and have been invoiced or their payment has been formally agreed upon with the suppliers. They generally show a low risk of uncertainty.

b) commitments;

Obligations to pay for the goods and services that have been received from suppliers or the latter have rendered them, but they have not yet been paid, invoiced or formally agreed upon their payment with the supplier. Although sometimes it is necessary to estimate the amount or exigibility of such debts, the element of uncertainty is generally much lower than for provisions. Commitments are often reported as part of commercial loan debts or debts of other origins, and provisions are reported separately.

c) provisions;

They are debts because they are current obligations and it is likely that outflows of resources should be required to embody the economic benefits to settle the obligations.

d) contingent liabilities that are not recognized as debts because they are either:

• possible obligations, yet for which one needs to confirm whether the entity has a current obligation that can generate a reduction of resources embodying economic benefits (e.g., a an unsettled dispute) or

• current obligations that do not meet the recognition criteria of *IAS 37*.

In some countries, the term "provision" is also used in the context of items such as depreciation, depreciation of assets and doubtful debts etc. and are not included in the above definitions.

Provisions are made up for items such as:

a) court disputes, fines and penalties, compensations, damages and other uncertain debts;

b) expenses related to warranty period service and other charges on the warranty ensured to clients;

c) decommissioning tangible assets and similar actions related thereto;

d) restructuring actions;

e) pensions and similar obligations;

f) taxes;

g) completion of employment contracts;

h) bonuses to be granted to the personnel based on the profits made, according to legal or contractual provisions;

i) provisions related to concession agreements;

j) provisions for non-gratuitous contracts;

k) other provisions.

There are certain characteristics of provisions that give rise to some issues in terms of their recognition in accounting. Uncertainty is such a feature of provisions and, therefore, it is necessary that professional judgment should intervene here to decide whether or not setting a provision is required.

The amount recognized as a provision must be the best estimate on the balance sheet date of the costs required to settle the current obligation. The best estimate of the costs required to settle the current debt is the amount that an entity would reasonably pay in order to settle the obligation on the balance sheet date or to transfer it to a third party at that time.

Where the effect of time-value of money is material, the amount of a provision is the updated value of the expenses expected to be required to settle the obligation. In this case, updating provisions takes place because, due to the time-value of money, the provisions related to resource outflows occurring shortly after the balance sheet date are more non-gratuitous than those related to resource outflows of the same amount, but occurring later.

Provisions must be reviewed and adjusted on each balance sheet date to reflect the current best estimate. If in order to settle an obligation, it is no longer probable that an outflow of resources should occur, the provision must be cancelled by resumption in incomes. Provisions are measured before setting the profit tax, their tax treatment being the one provided by tax legislation.

Example: A trading company deals with manufacturing computers and provides guarantees to the buyers of its products. The terms of the agreement stipulate that the manufacturer undertakes to approach, via repairing or replacement, any manufacturing flaws that occur within 2 years from the date of sale. Given past experiences, it is likely that there will be some applications to fulfil the warranty agreement.

The question arising is whether the company must recognize a provision in the account, if so to what extent and how its set-up will affect the financial and fiscal outcomes of the enterprise.

If one resorts to IAS 37 for recognizing a provision in the accounts, one must answer the following questions:

a) Is there a present obligation as a result of a past event?

The binding event is the sale of a product with a warranty, which gives rise to legal obligations.

b) Is it likely that there should be an outflow of resources meaning economic benefits used in a settlement?

It is likely for warranties taken as a whole. Therefore, according to the International Financial Reporting Standards, a provision must be made up for warranties to customers.

Measuring provisions is also difficult because costs may be committed only after many years (e.g. decommissioning is done at an asset's end of life), and the amounts can be unexpected (e.g. the damage to the environment can be difficult to measure) and with substantial values.

It may very often happen that the size of a provision set up be not sufficient. An illustrative example nowadays is the case of the German Volkswagen company which must pay exorbitant amounts at present due to past events. Has the German company properly assessed the risks and created sufficient provisions?

According to the Tax Code in Romania, the only provisions that are deductible are those set up for warranties to customers.

Provisions for performance guarantees to customers are made up quarterly only for delivered goods, performed works and rendered services during the respective quarter for which a guarantee is given in the following periods, at the level of rates provided for in the agreements or at the level of guaranteeing percentages stated in the tariffs of works performed or services rendered.

For construction works that require performance guarantees, according to the agreements, such provisions are made up quarterly, within the quotas set out in the agreements, provided there is the full reflection as incomes of the value of works performed and confirmed by the beneficiary on the basis of works reports.

Reporting the provisions made up for performance guarantees as incomes is done to the extent of expenses for remedies or upon expiry of the warranty period stipulated in the agreement.

Conclusions regarding Provisions:

a. provisions are meant to cover the liabilities whose nature is clearly defined and which on the balance sheet date are likely to exist or it is certain they will exist, but are uncertain in terms of their amount or the date on which they will occur.

b. by making up provisions, entities follow the principle of prudence, namely they do not overvalue their debts and undervalue their expenses and there is also a true and fair view of own assets, liabilities and equity;

c. making up provisions gives rise to deductible or non-deductible expenses (this is not important) which helps a company via the financial resources saved by not paying dividends, taxes or other bonuses (to employees, managers, stipulated in the management agreement etc.). So, the size of provisions directly helps a company by going up to the level of the “self-financing ability” indicator.

d. by making up provisions, a company shows financial stability, has ”reserves” available, accumulated through savings along with their set-up.

2. Treatment of Value Adjustments

The recognition and measurement of elements included in financial statements must consider the principles of accounting and also the tax rules in force, each subject to self-interests. Due to the relationship between accounting and fiscality, in practice certain cases are obvious where applying accounting principles is contradicted by tax rules. Such situations occur because certain principles governing accounting such as business continuity, prudence, fiscal year independence, are sometimes ignored by taxation or conflict situations arise that need to be reconciled.

Measurement in accounting is routinely performed upon the accounting recognition also known as initial evaluation of accounting elements, and also upon the reporting period, also known as further evaluation justified by certain times when initial evaluation can be corrected such as evaluation upon inventory, presentation of elements in a balance sheet and evaluation upon output.

The assets of an enterprise must be shown in a balance sheet at their book value (acquisition cost, production cost or other value which substitutes cost) minus the depreciation accumulated to date (for fixed assets), as well as along with the losses accumulated from impairment, thus resulting a net book value.

Value adjustments include all corrections meant to take account of reductions in the values of individual assets established on the balance sheet date whether or not the reduction is final. Depending on the permanent or temporary nature of impairment adjustment or asset loss of value, they may be: permanent adjustments called depreciations and/or temporary adjustments called impairment adjustments or loss of value. As a way of reporting, irreversible impairments are reported in accounting based on depreciation and reversible impairments based on impairment adjustments.

The procedures to close a financial year preceded by an annual inventory involve making estimates and reports which have the effect of adjustments to costs and incomes, as is the case of adjustments and provisions, they affect the outcome and as far as they are tax deductible, they also influence tax obligations.

Prudence demands that any element of the structure of financial statements should be presented based on the principle of prudence. The practical application of this principle includes:

- in accounting, only real profits are to be recognized on the date of closing a financial year, without taking account of probable profits;
- one must take into account all foreseeable obligations and all potential losses which have arisen during a financial year ended or during an earlier one, even if these obligations or losses arise between the end of the financial year and the date of balance sheet preparation;
- one must take into account all value adjustments due to impairments, whether or not the result of a financial year is a loss or a profit.

In conclusion, the principle of prudence recommends the use of any probable loss and the non-accounting of separate profits, even if they are very likely. The fiscal implications of the prudence principle are obvious, as the expenses reported for acknowledging impairment adjustments diminish the accounting result and implicitly profit tax to the extent they are tax deductible.

In practice, especially in smaller enterprises, there is a tendency to treat the making up of provisions and impairment adjustments in a subjective way, being addressed only in terms of immediate tax benefits.

Even if they are not fully deductible from a tax perspective, provisions and impairment adjustments of the values of asset elements, they must be an objective of the tax management within the enterprise.

Reporting the impairment of stocks during an inventory, bringing the cost of book-keeping to a net achievable value can be a potential source of accounting influence with tax effects, especially as impairment adjustments are inclusively reported for stocks without movement. If, for example, upon the inventory of asset elements, there is an impairment that would diminish their value over the book value, then the asset value must be reduced to the net achievable value, followed by the recognition of an expense related to adjustments for asset impairment.

During an inventory, the following management attitudes may arise:

- if the company management shows an accounting attitude oriented towards a lower tax result and implicitly a lower tax, it shall exclude the impaired assets from its inventory and the cost shall be recognized as an operating expense related to the adjustments for asset impairment.
- if the company management shows an accounting attitude oriented towards a higher tax result implicitly a higher tax, there will not be operating expenses related to adjustments for asset impairment. This kind of attitude also results in a better image in terms of financial position, the effects of non-reporting the adjustments being obvious in the balance sheet, as an overvaluation of stocks and assets implicitly has the effect of increasing own equity value.

Adjusting the book value envisages the reversibility of reduction in the book value relative to fair value. The difference between the book value and fair value is accounted for as adjustments of impairment. The accounts of impairment adjustments are corrective accounts of the input value/book value of tangible assets and are not in the category of own equity, but their value corrects the input value of the assets.

The accounting of impairment adjustments is performed through the prudence principle:

- if the book value is higher than the fair value, the difference is treated as a probable loss which, according to the principle of prudence, is reported as follows:

Impairment adjustment expenses = Impairment adjustments

- if the book value is lower than the fair value, the difference is treated as a probable gain which, according to the principle of prudence, is not reported, in order not to show fictitious profits and distribute dividends that may affect the company’s treasury and implicitly its decapitalization.

When the book value has an appreciation in relation to the fair value, or a tangible asset is no longer impaired, the impairment adjustments made up in previous years are reduced to the amount of depreciation reported in the year concerned or cancelled by the following accounting registration:

Impairment adjustments = Incomes related to impairment adjustments

Impairment adjustments directly affect the result of the year when they are incurred either upon their setting up via expenses or their resumption or cancellation via incomes.

Example no. 1 on the set up of value adjustments

On 31 December, in trade company N, upon preparing the annual financial statements, one proceeds as a preliminary step to the inventory of assets and liabilities. With this situation after centralizing the inventory lists there is the following synthetic situation for stock of goods "A".

- Inventory value ....3,500 lei
- Book value .... 4,000 lei

The present situation shows a value minus of 500 lei which is due to market conditions (recently a lot of import similar commodities have entered the local market which has led to cheapening similar goods).

According to the principle of prudence and in order to show a true and fair view of assets in annual financial statements, a company must show 3,500 lei in its balance sheet at the inventory value.

Basically, this (transition from the book value of 4,000 lei to the value inventory of 3,500 lei that provides a true and fair view) can be done this way:

- according to International Financial Reporting Standards, directly by reducing stocks in correlation with an expense account:

Expenses related to value loss	=	*Stocks (Goods)*	500 lei

- according to the regulations in Romania for setting a value adjustment:

Expenses related to value adjustments for impairment of current assets	=	Value adjustments for impairment of goods	500 lei

The solution chosen by normalizers aims at distinctly highlighting the value adjustments especially from tax reasons. In the financial statements, assets are shown at their:

Net Value = Book value – Value adjustments

Net value = 4000 – 500 =3500 lei.

In order to see the effects of registering or non-registering the value adjustments, here is a comparative situation in the profit and loss account:

Table no. 1. Comparative Issues in Profit and Loss Account Regarding Impairment Adjustments

Indicators	**Variant I Value adjustments are reported**	**Variant II Value adjustments are not reported**
1. Net turnover	85,000	85,000
2. Other operating incomes	2,500	2,500
3. Expenses related to goods	15,000	15,000
4. Material expenses	21,000	21,000
5. Expenses related with third parties	12,000	12,000
6. Employment charges	28,500	28,500
7. Expenses related to depreciation	1,800	1,800
8. Operating expenses related to adjustments for current asset impairment	500	0
9. Operating outcomes	**3,700**	**4,200**
10. Profit tax (it is equal in both variants, as adjustments for stock impairment is not tax deductible)	**672**	**672**

Conclusions:

a. Solutions on the registration of value impairment have the same effect in annual financial statements: assets are shown at their fair value - ensuring a true and fair view of a company's financial situation;

b. The big problem in our country is taxation, as such adjustment is not accepted as deductible by the tax code. This issue has two immediate consequences:

- Most entities (microenterprises and medium enterprises) no longer "get complicated" out of convenience or ignorance and no longer report impairment adjustments recorded at all, presenting the assets in their financial statements at an over-evaluated value. The immediate effect is that the amount of the year result is unduly higher, which can lead to the de-capitalization of the company by paying any dividends or bonuses to employees (if they are stipulated in the collective labour agreement). Additionally, by not setting up value adjustments, the company management can try hiding certain bad decisions that have led to these situations.

- the other entities (which report such impairment adjustments) want an as faithful presentation of their financial statements as possible. The effect of reporting impairment adjustments is that the assets are shown at their fair value on the one hand, and the year result reflects exactly the amount of profit or loss achieved. The great advantage for these entities is financial, not fiscal, namely value adjustments are calculated expenses which are part of the enterprise's self-financing ability;

c. The Tax Code states provisions are tax deductible (they are incorrectly called by the Tax Code, as they are actually impairment adjustments) set up for the impairment of accounts receivable as follows:

- provisions made up within a limit of 20% as of 1 January 2004, 25% as of 1 January 2005, 30% as of 1 January 2006, of the value of accounts receivable reported by the taxpayers that cumulatively meet the following conditions: they are registered after 1 January 2004; they are not collected within a period exceeding 270 days from the due date; they are not guaranteed by another person; they are payable by a person who is not affiliated to the taxpayer; they have been included in the taxpayer's taxable income;

- the reduction or cancellation of provisions is performed by shifting them to incomes in the event of collecting a debt, in proportion to the amount collected or its registration as expenses;

- as to debts in foreign currency, a provision is deductible at the level of the value influenced by favorable or unfavorable exchange differences arising when evaluating them. The amount of provisions for accounts receivable is taken into account in setting the taxable profit in the quarter when the conditions set out in the Tax Code are met and cannot exceed their value reported in accounting for the current fiscal year or in previous years.

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