



Study on the Application of the Prudence Principle in Accounting of Credit Institutions

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ABSTRACT

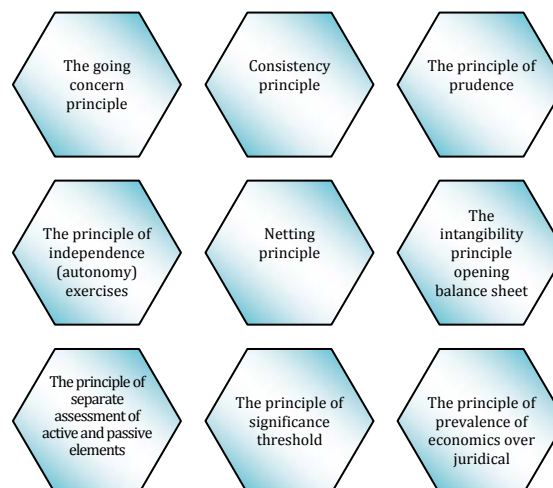
With effect from 1 January 2012, according to The NATIONAL BANK of ROMANIA No. 27/2010, International Financial reporting standards (IFRS) have become the basis of the accounting system used by credit institutions in Romania. In this context, the regulatory framework relating to the adjustments for impairment of financial assets other than loans and securities is given by IAS 39 and IAS 37. In this paper we propose to develop a study on the application of the prudence principle in accounting of credit institutions, a study, which will be the main issues of taxation and accounting implementation of prudent credit institutions.

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1. Introduction

Accounting principles are the conceptual elements required legislators in the drafting of accounting standards and accounting professionals in the process of drawing up and approval of the financial statements. Accounting regulations harmonized with Directive IV of the European and International Accounting Standards have withheld from these nine principles, (see figure below):

The nine accounting principles in accounting Regulations harmonized vision with Directive IV of the European and International Accounting Standards



Source Own adaptation after OMFP 3055/2009.

2. The prudence principle

According to financial and banking dictionary the prudence principle role is to avoid a future transfer of the uncertainties of the present. According to this principle it will cover certain losses and probable, but not certain, revenue and income. In banking accounts exceptions to this principle occur, in particular, market operations with securities transaction (1).

According to OMFP 3055/2009 (2), with subsequent amendments and additions to the principle of prudence requires that: at the preparing of the annual accounts, an assessment must be made on a prudent basis as shown in the figure below:

Rules for the application of the principle according to OMFP 3055/2009



a) in the profit and loss account can be included only the profit realized to the date of the balance sheet;



b) account must be taken of all the debts incurred during the current financial year or previous year, even if they become apparent only between the date of the balance sheet and the date thereof;



c) account must be taken of all foreseeable liabilities and potential losses arising in the course of the current financial year or a previous fiscal year, even if they become apparent only between the date of the balance sheet and the date of its drawing up.

For this purpose, any provisions and liabilities arising out of contractual clauses are concerned;



d) account must be taken of all depreciation, regardless of whether the result for the financial year is a loss or profit. Recording of the adjustments for impairment or loss of value shall be carried out on according to the expense accounts, regardless of their impact on the profit and loss account..

Source Own adaptation after OMFP 3055/2009.

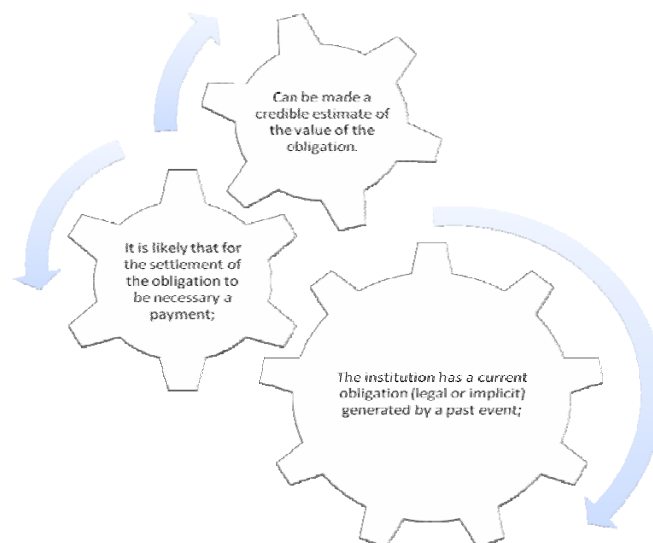
As a result, assets and incomes shall not be overstated and liabilities and charges, undervalued. However, exercising prudence does not allow, for example, the creation of excessive provisions, deliberate undercutting of assets or income, but not deliberate overvaluing of spending or debt, because the financial statements would not be neutral and would no longer have the quality of being credible.

According to this principle in the assessment of costs and revenue the risks, depreciation and possible losses arising from activity in the current or previous year must be taken into account. Thus overvaluing suited assets or income is not allowed (3), respectively undercutting the spending or passive elements, taking into account the risks, depreciation and possible losses, generated by current or future activity. The principle of conservatism is organically linked to the heritage assessment, assessment which is carried out in four moments: at the date of entry in heritage, at the date of valuation, at the end of the year and the date of removal of the heritage or the putting in use. The first two moments creates prerequisites for the application of the prudence, and the third one effectively creates the application of this principle. Thus, at the end of the year a real heritage should be established, regardless of the prices used for recording in the accounting, which could make the price of the day.

As a result, taking into account the actual losses (depreciation) found – amortization – and foreseeable losses and write-downs corresponding provision, shall ensure their influence over the outcome of the establishment period. The difference between the book value minus the items inventoried property and free market prices shall be deemed provision. Application of prudence should not lead to the creation of hidden reserves or creating excessive use provisions. In the credit institution point of view provisions are regarded as an uncertain debt, for the point of view of chargeability period or value. A provision will be recognized in the accounts, and then only when they fulfill the conditions indicated in the following figure:

Conditions for the recognition of provision in the accounts of credit institutions

The institution has a current obligation (legal or implicit) generated by a past event;

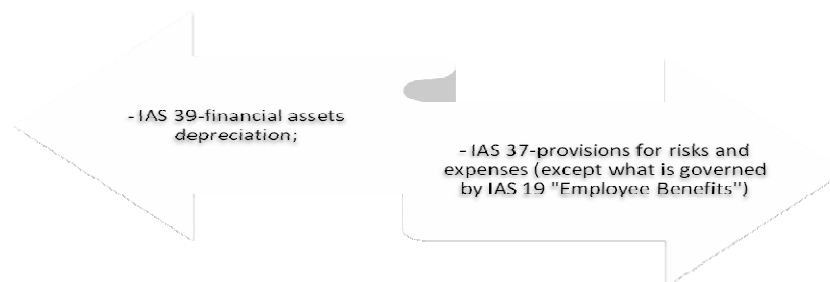


Source Own adaptation after the Decizia Comitetului de Directie a BRD nr. 1475/10.01.2014 (4)

3. Provisions for liabilities and charges and adjustments for depreciation of financial assets, in credit institutions vision

With effect from 1 January 2012, according to The NATIONAL BANK of ROMANIA No. 27, 2010, the international standards of Financial Reporting (IFRS) became the basis of the accounting system used by credit institutions in Romania. In this context, the regulatory framework relating to the adjustments for impairment of financial assets other than loans and securities is given by IAS 39 and IAS 37 (4).

Regulatory framework concerning the adjustments for impairment of assets



Source Own presentation

Provisions for liabilities and charges will be recognized for liabilities arising out of: litigation, as it makes claims against the Credit institution (the institution has the quality of complained); taxes and tax litigation; other liabilities and charges.

As a rule, provisions for liabilities and charges are founded on the obligation of payment of estimated future. In the case of disputes for which you are calculating the amount of the provisions, the provision will take into account the judgment and costs associated with the file, at the payment to which the credit institution might be obligated, in so far as they may be estimated.

Recording in accounting of the establishment/increase in depreciation and adjustments for provisions for liabilities and charges are reflected in the period in which the expenditures have been recorded (corresponding counts in 3 and 5 class). Cancellation/adjustments for depreciation and reduction of provisions for liabilities and charges is made by recording on the income for the year in which those findings were held. Cancellation/reduction is achieved at the moment the level of depreciation/output resource risk diminishes/no longer exists.

Determination is made for each of the entities that manage accounting adjustment for depreciation/provision respectively.

Provisions for liabilities and expenses need to be updated at each balance sheet date and adjusted to reflect the current best estimate.

Updating of provisions for liabilities and charges represent an increase in value of provisions due to the passage of time (6657xxx = 55xxxx).

In case of disputes, the update can be done according to the existing information in the application concerning disputes relating to claims by the complainants, in accordance with the provisions of the judgment summons applications. In this respect, for updating of provisions for liabilities and charges, will be sought the opinion of the legal adviser/lawyer who manages the file in court. Use of the adjustment for depreciation/provision shall take place at the moment the risk occurred and the institution recorded a loss/out of resources.

In the case of debts, estimated recovery period is 1 year from the date of registration of the arrears, at which point it will extinguish the claim by using the adjustment for depreciation (39xxx = 38xxx), except those for which there is a legal procedure.

In the case of provisions for liabilities and charges, use of the provision implies its passage on income at the same time with recording of spending on resources exits.

The tax treatment – According to art. 22 of the Law nr. 571/2003 concerning the fiscal code (6), adjustments for depreciation and provisions for liabilities and expenses are not tax deductible.

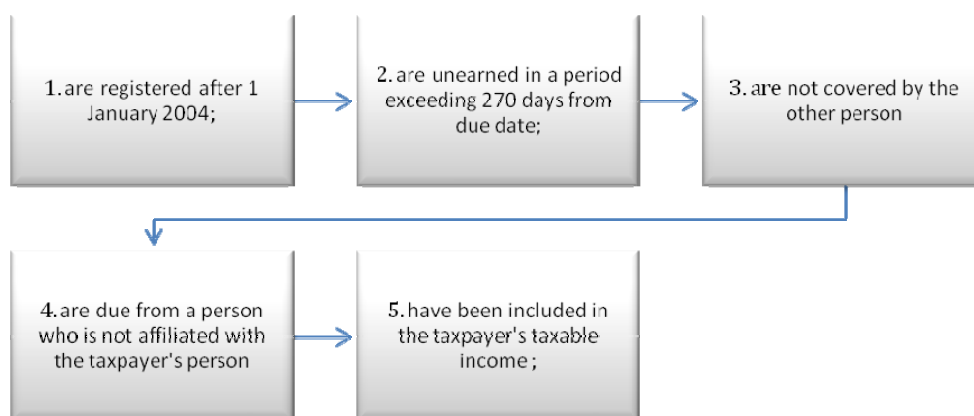
According to art. 22 of the Law 571/2003 The taxpayers has the right to reserve deduction and provision, only according with this, following:

a) the legal reserve is deductible up to a maximum quota of 5% applied to the accounting profit, before determining corporation tax, minus non-taxable revenues and costs are added to these non-taxable income, until it will reach the fifth part of the share capital subscribed and paid up, or heritage, after case, according to the laws of organization and operation. Where it is used to cover losses or distributed in any form, subsequent reconstitution of the reserve is no longer deductible in the computation of taxable profit. By exception, the reserve established by legal persons providing public utilities companies which restructures, reorganize or is privatizing can be used to cover the losses of the stock value obtained as a result of the conversion of receivables, and the amounts intended for subsequent reconstitution of it are deductible when calculating taxable profit;

b) the provision for guarantees of performance provided to customers;

c) provision constituted up to a 20% with effect from 1 January 2004, 25% with effect from 1 January 2005, 30% with effect from 1 January 2006, of the value of claims on customers, recorded by contributors, other than those referred to in letter. d), f), g) și i), which cumulatively fulfills the following conditions:

Conditions for the deduction of provisions in the light of the provisions of art. 22 letter c of Law 751/2003 updated



Source Own adaptation after the art. 22 of Law 571/2003 (6)

d) specific provisions, constituted by non-banking financial institutions enrolled in general ledger kept by the National Bank of Romania, by payment institutions Romanian legal persons granting credit related to payment services, by the electronic coin issuing institutions, Romanian legal entities, granting credit related to payment services, as well as specific provisions constituted by other legal persons, according to the laws of organization and operation;

d^1) adjustments for assets impairment for which, according to prudential regulations of the National Bank of Romania, determines the prudential value adjustments or, after case, values of expected

losses, recorded by credit institutions Romanian legal entities and branches of credit institutions of Romania from countries that are not part of EU or in countries which do not belong to the European Economic area, according to accounting regulations in accordance with international financial reporting Standards, and prudential filters according to regulations issued by the National Bank of Romania. The amounts corresponding to the reduction or cancellation of prudential filters are similar items of revenue;

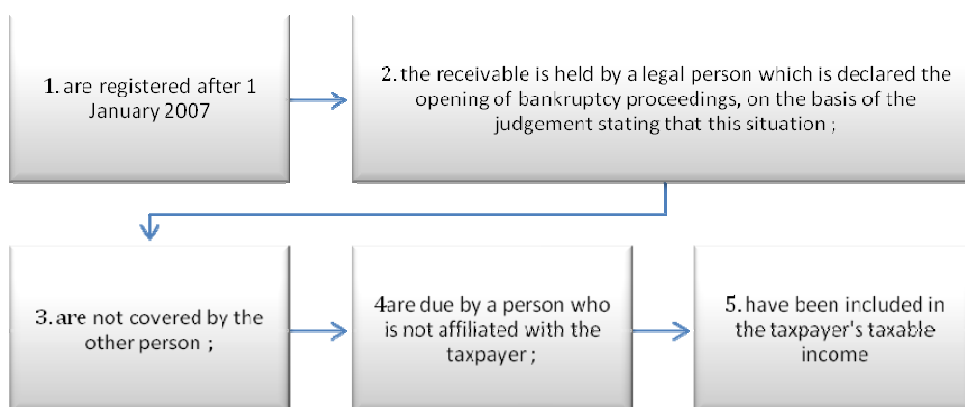
d^2) adjustments for depreciation recorded by branches from Romania of credit institution of the member States of the European Union and countries belonging to the European Economic area, According to accounting regulations in accordance with international financial reporting Standards, related to loans and investments that fall within the scope of prudential regulations of the National Bank of Romania relating to prudential value adjustments applicable to credit institutions of the Romanian legal person Romanian branches of credit institutions from states that are not members of European Union or in States which do not belong to the European Economic area;

h) the technical reserves established by the insurance and reinsurance companies, according to legal provisions and operation, with the exception of the equalization reserve. For insurance contracts ceded for reinsurance, the reserves shall be reduced so as to cover the level of risk that remains in charge of the insurer, after deduction of reinsurance;

i) risk provisions for its operations in the financial markets, set up according to the regulations of the National Commission for Estates Values;

j) provision constituted as a percentage of 100% of the value of the customer claims, recorded by contributors, that they meet all the following conditions:

Conditions for the deduction of provisions in the light of the provisions of art. 22 letter j from Law 751/2003 updated



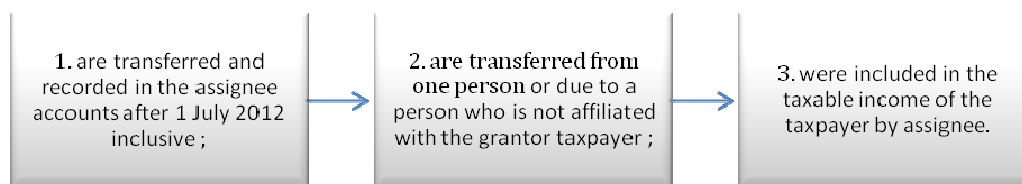
Source Own adaptation after the art. 22 of Law 571/2003 (6)

k) the provision for the closure and post closure monitoring of landfills, set up by taxpayers engaged in waste storage, according to law, within the limit of the amount set out in the draft for the closure and post closure of the warehouse tracking, appropriate share-parts in storage charges levied;

l) the provision set up by the airlines of Romania to cover the costs of maintenance and repair of aircraft and related components, according to the aircraft maintenance programs, approved by the Romanian Civil Aeronautical Authority. Detailed rules

m) provisions for impairment of receivables adjustments/collected from credit institutions in order to recover them, within the limit of the difference between the value of the claim taken from the grant and the payable amount to the transferor, for claims that meet the following cumulative conditions:

Conditions for the deduction of provisions in the light of the provisions of art. 22 letter m of Law 751/2003 updated



Source Own adaptation after the art. 22 of Law 571/2003 (6)

6. Conclusion

In our opinion, application of the principle of precaution adds new meanings in the macroeconomic context affected by financial crisis, especially in the banking units currently subject to a high credit risk in case of a severe economic instability and who see themselves forced to devise increasingly complex methodologies for the implementation and application of this principle.

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