

LEGAL RESERVES, PROVISIONS AND ADJUSTMENTS FOR TAX DEPRECIATIONS

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Abstract: *The paper refers to the Romanian companies that carry out business activities and pay profit taxes. Legal reserves, provisions and adjustments for depreciation are taken into account in calculating the financial result within the limits provided by the Fiscal Code. The solution of the theoretical and methodological aspects was argued with the legal provisions in the accounting and fiscal field.*

Keywords: Financial result, profit tax, legal reserves, provisions, adjustments for depreciations.

JEL Classification Codes: M41, K34.

1. FINANCIAL RESULT

In the case of profit tax payers, the financial result is calculated by applying the rules provided by the Fiscal Code and the related norms. More specifically, the total expenses are deducted from the total incomes, subsequently, the non-taxable incomes are taken into account with the minus sign, the amounts used for the establishment or increase of legal reserves are deducted, the non-deductible expenses are added, the fiscal loss is deducted, and the result of these operations coincides with the financial result. The financial result is multiplied by the legal tax rate and the due profit tax is obtained.

In this paper, we will refer to the companies registered as profit tax payers and we will present the fiscal and accounting treatment of the legal reserve and of the expenses generated by the establishment of provisions and adjustments for the depreciation of assets.

2. ACCOUNTING AND FISCAL REGIME

The legal reserves, constituted within the limits provided by the Fiscal Code, are taken into account in the calculation of the financial result with minus sign.

The obligation to establish the legal reserve is provided by Companies Law no. 31/1990 (as updated), which at art. 183 para. 1) establishes the rule according to which “Every year, at least 5% of the company profit will be taken over for the constitution of the reserve fund, until it reaches at least one fifth of the share capital”.

From the accounting point of view, Order 1802/2014, provides in subsection 5: 4.13.4. Legal reserves and other reserves, point 419 (2) The legal reserves are constituted annually from the profit of the entity, within the quotas and limits provided by law, and from other sources provided by law.

The fiscal code provides in Art. 26 let. a) that “the legal reserve is deductible up to a rate of 5% applied to the accounting profit, to which the income tax expenses are added, until it reaches one fifth of the subscribed and paid-in share capital or of the patrimony, as appropriate”.



From the aforementioned provisions, we can note the following aspects: a) companies have the obligation to constitute a legal reserve within the limits provided by the Companies Law; b) Order 1802/2014 provides for its annual establishment, inferring that the amounts used for the establishment or increase of the legal reserves are accounted for on 31st December; c) The Fiscal Code clarifies the aspects related to the limits of the tax deduction, referring to the paid-in and subscribed share capital.

Example: As at 12/31/2019, the total income is 20,000,000 RON; the total expenses 18,000,000 RON and do not include non-deductible expenses and expenses with the profit tax. As at 01/01/2019, account 1061 Legal reserve had a credit balance of 25,000 RON. As at 31/12/2019, account 1012 Subscribed and paid in share capital had a credit balance of 200,000 RON.

The deductible legal reserve for the calculation of the financial result of 2019 will be the smallest amount resulting from the following two calculations:

Gross profit (20,000,000-18,000,000)x5%=100,000 RON

Gross profit (20,000,000-18,000,000) x 5% = 100,000 RON

Subscribed and paid-in share capital 200,000 x 1/5 = 40,000 RON maximum limit, so the reserve will increase by 40,000-25,000 = 15,000 RON, Entry in the accounting records:

Table no. 1-The increase in the legal reserves

<i>Income statement</i>	
<i>129=1061</i>	<i>15,000 RON</i>
<i>Verified by</i>	<i>Prepared by</i>

Key: 129 Profit distribution; 1061 Legal reserves.

Legal provisions: The amounts representing reserves constituted from the profit of the current financial year, based on certain legal provisions, are recorded under the accounting item 129 “Profit appropriation” = 106 “Reserves”. The accounting profit remaining after this appropriation is taken over at the beginning of the financial year following the one for which the annual financial statements are prepared in account 117 “Other retained earnings”, from where it is to be distributed to the other purposes decided by the general meeting of shareholders in compliance with the legal provisions. *Source: Order of the Minister of Public Finance 1802/2014 ITEM 421*

Provisions are constituted in compliance with the principle of prudence. Thus, **at the date of the balance sheet**, all foreseeable liabilities and potential losses that occurred during the respective financial year or during a previous year must be recognized, even if they become apparent only between the date of the balance sheet and the date of its preparation.

We can conclude that the provisions are debts with probable nature and they are reported separately in the liabilities of the balance sheet, as opposed to the adjustments, which are corrective values.

Out of the total of the known provisions, only the Provisions for the guarantees granted to the customers are deductible, if we refer to the accounting of the companies established based on Law no. 31/1990.

The Fiscal Code provides in Art. 26 let. b) that the provisions for performance bonds granted to customers are deducted quarterly/annually only for the goods delivered, works performed and services provided during the respective quarter/year for which a bond is granted in subsequent periods, at the level of quotas provided in the agreements concluded or the level of the guarantee percentages provided in the tariff of the executed works or the provided services

Example: A company invoices construction and assembly works executed in the first quarter of 2019. The invoice is worth 11,900 RON, including 19% VAT. For these works, the builder has the obligation to establish a performance bond in the amount of 200 RON. The guarantee will be kept at the disposal of the client for a period of 2 years and will be recovered after the expiration of the guarantee period, if no quality defects appear.

In order to reflect in the accounting the operations generated by the issuance of the invoice and the constitution of the performance bond, we further present the chain of the accounting records.

Table No. 2-Constitution of the performance bond

Income statement					
It. No.	Explanations	D	=	C	Amount - RON -
1	Issuance of the invoice	4111	=	%	11,900
				704	10,000
				4427	1,900
2.	Settlement of the invoice and constitution of the performance bond	%	=	4111	11.900
		5121			11,700
		2678			200
3.	Constitution of the provision covering the risk related to the non-recovery of the performance bond	6812	=	1512	200
Verified by			Prepared by		

Key: 4111 Customers; 704 Services rendered; 4427 Output VAT; 5121 Cash at bank in RON; 2678. Other long-term receivables; 6812. Provisions for risks and charges; 1512 Provisions for guarantees to customers.

Note: For 2019 the expense recorded in the debit of account 6812 is deductible when calculating the profit tax,

After the expiration of the guarantee period of the construction and assembly works, the guarantee is recovered and the provision is cancelled. The accounting records chain is presented below:

Table No. 3- Recovery of the performance bond

Income statement					
It. No.	Explanations	D	=	C	Amount - RON -
1	Recovery of the performance bond	5121	=	2678	200
2	Cancellation of the provision that has become devoid of purpose	1512	=	7812	200
Verified by			Prepared by		

Key: 5121 Cash at bank in RON; 2678. Other long term receivables; 1512 Provisions for guarantees to customers; 7812 Write back of provisions for risks and charges.

Note: The incomes entered in the credits of account 7812 are taxable because they resulted from the cancellation of a deductible provision,

Adjustments for depreciation have the role of highlighting the value of individual assets at the balance sheet date. Thus, the accounting regulations approved by Order 1802/2014 state the rule according to which the inventory valuation of receivables is made at their probable collection value. The differences in minus between the inventory value established at the inventory and the book value of the receivables are recorded in the accounting records on account of the adjustments for the depreciation of the receivables.

Example: At the end of the financial year, the debit balance of account 4111 Customers account is 1500,000 RON, out of which 18,000 RON represents the value of the outstanding invoices that have exceeded 270 days from the due date.

Observation: It is necessary to entry the outstanding invoices from Customers to Doubtful customers or customers involved in litigation simultaneously with the establishment of an adjustment for the depreciation of customer receivables.

Table No. 4
- Impairment of customer receivables

<i>Income statement</i>		
<i>4118</i>	<i>=4111</i>	<i>18,000 RON</i>
<i>6814</i>	<i>=491</i>	<i>18,000 RON</i>
<i>Verified by</i>		<i>Prepared by</i>

Key: 4111 Customers; 4118 Doubtful customers or customers involved in litigation; 6814. Write-down of current assets; 397. Write-down of goods.

From the fiscal point of view, the adjustments for the depreciation of the receivables are deductible when calculating the taxable profit within a quota of 30% of their value. Deductibility is granted subject to the following conditions: 1. They are uncollected within a period exceeding 270 days from the due date; 2. They are not guaranteed by another person; they are owed by a person who is not a person affiliated to the taxpayer, Source: Art. 26 let. c) of the Fiscal Code approved by Law 227/2014.

Observation: Given the limits of the fiscal deductibility of 30%, it results that from the total of 18,000 RON, which represents the value of the adjustment, 5,400 RON are deductible expenses, and the difference of 12,600 RON represents non-deductible expenses, In the case of clients declared bankrupt, the Fiscal Code precedes Art. 26 let. J) the fiscal deductibility of 100% of the expenses generated by the constitution of the adjustments for the uncollected invoices.

In support of this statement we present the content of the aforementioned provisions: adjustments for the impairment of receivables entered in the accounting records according to the applicable accounting regulations, up to a percentage of 100% of the value of receivables, other than those provided in letters d), e), f), h) and i), if the receivables cumulatively meet the following conditions:

1. they are held by a legal entity form whom the insolvency proceedings are declared, on the basis of the court decision attesting to this situation, or by a natural person for whom insolvency proceedings are opened on the basis of:

- debt repayment plan;
- liquidation of assets;
- simplified procedure;

2. are not guaranteed by another person;

3. are owed by a person who is not affiliated with the taxpayer;

In the case of inventoried stocks, there can be differences in minus between the inventory value and the accounting book value. These differences are the consequence of reversible depreciations and are recorded at the expense of the adjustment accounts for the depreciation of inventories.

Example: On the occasion of the annual inventory of the stocks of goods, stocks that are difficult to sell were found with a book value of 15,000 RON and an inventory value of 14,500 RON. The inventory commission proposes to maintain the retail price and to establish an adjustment for impairment,

Table No. 5
Establishing an adjustment for the depreciation of goods

<i>Income statement</i>		
6814	=397	500 RON
<i>Verified by</i>		<i>Prepared by</i>

Key: 6814 Operating expenses related to adjustments for impairment of current assets 397 Adjustments for impairment of goods.

Observation: In the case of irreversible depreciations, two different situations arise: a) from causes that are not related to extraordinary events; b) due to natural disasters and other extraordinary events.

Example: Planting materials with a book value of 9,500 RON are inventoried and it is found that 20% are irreversibly impaired due to natural disasters and 10% are irreversibly impaired due to storage in inappropriate conditions. The irreversibly impaired planting materials are written off.

Table No. 6- Irreversible impairments

Income statement						
It. No.	Explanations	D	=	C	Sum	-RON-
1	Writing off impaired planting material due to causes related to extraordinary events	6587	=	3025		1900
2	Writing off impaired planting material due to causes not related to extraordinary events	6025	=	3025		950
Verified by				Prepared by		

Key: 3025. Seeds and sapling; 6025. Expenses related to seeds and sapling; 6587 Expenses related to disasters and other similar events.

From a fiscal point of view, according to Art. 26 (4) let. c) of Law 227/2015, the following are not deductible: the expenses related to the goods of the nature of stocks or of the depreciable fixed assets found missing from management or degraded, not imputable, as well as the related value added tax, if it is due according to the provisions of title VII. These expenses are deductible in the following situations/conditions:

1. depreciable goods/fixed assets destroyed as a result of natural disasters or other causes of force majeure, under the conditions established by the provisions;
2. goods/fixed assets for which insurance contracts have been concluded;
3. qualitatively degraded depreciable goods/fixed assets, if the destruction is proved;
4. foodstuffs intended for human consumption, with the expiry date of consumption almost ended, other than those in the situations/conditions provided for in points 1 and 2, if their

transfer is carried out in compliance with the legal provisions regarding the reduction of food waste;

5. by-products of animal origin, not intended for human consumption, other than those in the situations/conditions provided for under points 1 to 3, if their disposal is carried out in compliance with the legal provisions regarding the reduction of food waste;

6. agricultural products, which have become unfit for human or animal consumption, if the targeting aims at their transformation into compost/biogas or their neutralization, according to the legal provisions concerning the reduction of food waste

3. CONCLUSIONS

The correct determination of the financial result has a special importance in the relationships that are established between the taxpayer and the state budget.

The legal reserves are deducted within the limit of 5% of the gross profit, without the balance of account 1061 Legal reserves exceeding 1/5 of the subscribed and paid-in share capital.

Out of the total of the provisions, only the Provisions for guarantees granted to the customers are deducted, if they are constituted in compliance with the conditions provided by the Fiscal Code.

In the case of uncollected invoices, adjustments are made that can be partially or totally deductible. They are fully deductible if the uncollected invoices are issued to clients declared bankrupt.

Adjustments for depreciation of inventories are non-deductible. There are also exceptions, provided by the fiscal law, where the adjustments for the depreciation of stocks are deducted.

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