APPLYING THE PRUDENCE PRINCIPLE IN NON-PROFIT ORGANIZATIONS AND FINANCIAL INSTITUTIONS

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Abstract

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The paper describes in detail the accounting principle of prudence in non-profit organizations and financial institutions. It defines its application in such organizations and based on comparison it evaluates the practical use of the prudence principle and its reflection in the accounting books. The main focus is on differences in applying the prudence principle that result from differences in the purpose, activities and methods of asset management in these organizations. The practical application of the prudence principle in accounting consists mainly in the creation and use of provisions and impairments. These methods are defined by the Implementing Regulation to the Accounting Act No. 563/1991. The paper also provides tables where the creation and use of impairments and provisions in the above-mentioned organizations is compared with how business companies proceed in creating impairments and provisions.

The key legislation standardizing accounting in the Czech Republic is the Accounting Act No. 563/1991, as amended, which stipulates the general accounting principles, the so-called accounting philosophy. The accounting is built around the general accounting principles, which are perceived as the pillars of accounting. Even though they are not stipulated in any particular law, they are legally enforceable and their ignorance can be sanctioned. The general accounting principles represent a set of rules to be observed in keeping the accounting books, preparing the accounting reports and submitting the accounting reports to users. The keystone accounting principle is the principle of true and fair reflection of facts the essential goal of which is to report in the financial statement actual assets and the financial position of the accounting unit with an essential focus on reporting events that occurred during the accounting period with respect to their content.

fair and true principle, provision, impairment, financial institutions, non-profit organizations

Preparing a financial statement in line with the principle of the true and fair reflection of the reality means to respect another accounting principle, the principle of prudence. The prudence principle basically represents a reasonable estimate that tries to avoid carrying current risks into the future because then they could burden the company's net worth and worsen its financial position or profit. In accounting practice, this means reporting only actual and realized profits. However, in case

of losses, it means reporting not only those that are certain but also those that are contingent and expected in view of all known facts and the depreciation of assets even though it has not yet occurred and its amount cannot yet be reliably established. Various accounting methods can be used in the practical application of the prudence principle. As well as a realistic pricing of assets and liabilities these methods include namely the creation and use of provisions and impairments.

Accounting methods relating to impairments and provisions in various types of accounting units are defined in the Implementing Regulation to the Accounting Act No. 563/1991. In particular, it is the Implementing Regulation No. 504/2002 for non-profit organizations, which implements some regulations of the Accounting Act No. 563/1991 concerning the book keeping in accounting units where profitable business is not the main objective provided they use double-entry accounting, and the Implementing Regulation No. 410/2009, which implements some regulations of the Accounting Act No. 563/1991, as amended, concerning selected accounting units. The applicable implementing regulations for financial institutions are No. 501/2002 implementing some regulations of the Accounting Act No. 563/1991 concerning accounting units which are banks and other financial institutions under stipulations of the Implementing Regulations Nos. 398/2005 and 502/2002 implementing some stipulations of the Accounting Act No. 563/1991, as amended, concerning accounting units which are insurance companies.

The Implementing Regulations do not define these accounting methods in a uniform manner. This would be impossible considering the diversity of legal forms, spheres of business and objectives for which the accounting units have been established.

OBJECTIVES AND METHODS

The aim of this paper is to evaluate by way of comparison the practical application of the prudence principle and its reflection in the book keeping of various accounting unit types. More specifically, the paper will focus on impairments and provisions. The paper provides information about these accounting methods used in non-profit organizations which proceed in line with the Implementing Regulations Nos. 410/2009 and 504/2002 and in financial institutions proceeding in line with Implementing Regulations Nos. 501/2002 and 502/2002, as amended. For completion, there is a brief comparison with how business companies proceed in creating impairments and provisions.

In order to achieve this goal we used namely analyses of legislation governing these issues in the above-mentioned types of entities and then we compared their outputs. The researched sources were mainly the relevant implementing regulations issued by the Ministry of Finance of the Czech Republic, Czech accounting standards, relevant

international accounting standards as well as internal guidelines of several business companies, banks, insurance companies and non-profit organizations. The method of synthesis was used to draw conclusions.

RESULTS AND DISCUSSION

Accounting methods applied with respect to the prudence principle in non-profit organizations keeping books under the Implementing Regulation No. 410/2009

As of 1 January 2010, all accounting units in public administration that run accounting books in full scope have been subject to the obligation to apply new and so far unused accounting methods. It is especially the method of making impairments for receivables, creating provisions, making deferrals and accruals and appraising assets at actual value. Since 1 January 2011, the accounting units are obliged to create impairments for other assets as well (i. e. including fixed assets and inventories) and, at the same time, they will have to depreciate fixed assets. These accounting methods are introducing the accruals principle in public administration accounting. As regards the prudence principle, impairments and provisions are an innovation in the book keeping of public administration. The following table clearly indicates in which accounting units and in which cases these accounting methods were already used in the past.

Impairments for receivables and other assets

Accounting units became obliged to create impairments to receivables in 2010. In case of impairments to other assets, this obligation has been postponed until 2011. The procedure of creation and use of impairments is laid down in Section 65 of the Implementing Regulation No. 410/2009. Paragraph 1 of this Section says among other things that impairments are to be made on the basis of the assets stocktaking. However, paragraph 2 offers information that if the accounting unit's assets value drops significantly for a period of time, then the event is accounted for without undue delay. As significant is considered a more than 10% reduction in the asset value. Section 65, paragraph 3 of the Implementing Regulation suggests that impairments are not to be created for assets that are appraised at actual value or equivalent (counter value) and for assets that are appraised at 1 CZK.

I: Accounting methods applied by accounting units

Accounting method	Situation until 31 December 2009			Situation from 1 January 2010
	OSS, SF	ÚSC	PO	
Impairments	no	only economic activity	only economic activity	yes
Provisions	no	only economic activity	only economic activity	yes

Source: MINISTRY OF FINANCE (2008), (adapted)

Notes: OSS = government entities, SF = state funds, ÚSC = self-governed territorial units, PO = allowance organizations

Pursuant to the Implementing Regulation, impairments to receivables are to be created in two cases. The first case is stipulated in Section 65, paragraph 6 of the Implementing Regulation, under which an impairment of 10% is made for each complete 90 days after the due date of the receivable. If this situation occurs, the impairment is obligatory. The other case, which is not obligatory however, is derived from the regulations of Section 65, paragraph 4 of the Implementing Regulation under which it is possible to make impairments also in cases stipulated in the Act No. 593/1992 on provisions ensuring an income tax base, as amended. Another important regulation is Section 23, paragraphs 1 and 2 of the Implementing Regulation which determines accounts for which impairments to receivables need not be made. The extensive list does not include several accounts and we can deduce from this fact that impairments are expected to be made to them.

The objective of *creating impairments to receivables* is to bring the receivable's value closer to reality. The main idea of this accounting method is to obtain a more realistic view. Until the end of 2009, receivables were registered in their original value throughout the collection period. The cost was incurred only at the moment of their depreciation. The aim of the current enactment is to create costs with the gradually diminishing chance of recovery that would cover a single write-off of the receivable after an adequate period of time. Since the beginning of 2011, beside impairments to receivables, organizations are required to make impairments to other assets as well.

The creation and accounting of impairments are allocated to costs using a so-called net method. Impairments are created to the debit of costs and later settled in favour of costs.

Creating provisions

The creation and use of provisions are governed by the regulations stipulated in Section 67 of the Implementing Regulation No. 410/2009. Paragraph 1 says among other things that provisions are to be created in order to cover future liabilities or expenditure the purpose of which is known, they are likely to arise but the exact amount and date are usually not known. The Accounting Act, in the regulations of Section 26, paragraph 3 defines that provisions are understood to be reserves for risks and losses, reserves for income tax, reserves for pensions and similar liabilities, reserves for restructuring, technical reserves and the like. An accounting unit can therefore create provisions e.g. for planned asset renovations, land reclamation, possibly also for future fines and sanctions of which it is aware but does not know the exact date of payment. The only situation in which provisions cannot be created under the regulations of Section 67, paragraph 5 of the Implementing Regulation No. 410/2009 is impairment to asset appraisal. Provisions are debited to costs and their settlement

is credited to the same cost account. This is a so-called net method of accounting, which means that both the creation and drawing of provisions are accounted through the costs.

Accounting methods following the prudence principle in non-profit organizations keeping books under the Implementing Regulation No. 504/2002

Accounting units that have not been established for business purposes apply the regulations of the Accounting Act in respect of creating and drawing on provisions and in respect of impairments, depreciation of assets and in respect of the actual value in line with the accounting methods laid down in Chapter 4 of the Implementing Regulation No. 504/2002 implementing some regulations of the Accounting Act No. 563/1991, as amended, applicable to accounting units where profitable business is not the main objective, if they use double-entry accounting (Implementing Regulation No. 504/2002). Accounting methods related to the prudence principle, i.e. impairments and provisions, are therefore applied in a limited way only. They are not created under the Accounting Act and their creation in such organizations can be considered only if they are impairments or provisions under the Act No. 593/1992 on provisions ensuring an income tax base, as amended (Provisions Act).

Impairments

Accounting units governed by the Implementing Regulation No. 504/2002 do not make impairments that reflect a temporary reduction in asset value under the Accounting Act No. 563/1991. Impairments to imprescriptible receivables are an exception in circumstances stipulated namely in Sections 8, 8a to 8c of the Provisions Act. These impairments are made only in cases where their creation is related to activities that are subject to income tax. It is therefore important for the application of impairments that income from the activity to which it relates be subject to income tax.

Creating impairments is debited to costs, the reduction or deletion of a created impairment is credited to a relevant revenue account. Thus, the accounting method used is a so-called gross method.

Accounting units report impairments made under the Act No. 593/1992 as negative figures in assets on the balance sheet. Unlike in business companies, the balance sheet under the Implementing Regulation No. 504/2002 does not contain 3 columns (gross assets, correction, net assets). The asset correction is therefore made by adding a minus sign.

Creating provisions

Accounting units listed in Section 2, paragraph 1 of the Implementing Regulation No. 504/2002 (non-profit organizations) in creating provisions proceed in line with the regulations of Section 40; they do not create provisions defined in Section 25 paragraph 3

and Section 26 paragraph 3 of the Accounting Act. They neither account for such provisions, nor report them in balance sheet items in the financial statement. The reason for such procedure is the fact that profits are used to fund the organization's principal activity defined in the trust deed or in another document establishing the corporate entity. If accounting units consider it as important to report information about a temporary reduction in the asset value, risks that can affect their future financial situation or the value of assets or liabilities, it is appropriate to report such information by way of description and/or financial appraisal in notes attached to the financial statement. In this way it is possible to provide a true and fair view of the financial situation in units established and incorporated for other than profitable activities to users of the balance sheet, profit and loss statement and notes to financial statement. Accounting methods defined in Section 40 of the Implementing Regulation No. 504/2002 make it possible for non-profit organizations to create provisions only if they are provisions recognized by the Provisions Act and only if the cost of their creation is a cost of achieving, securing and maintaining income. It follows from the above that if a non-profit organization has no taxable income or has only income that is not subject to taxation or has only income that is exempt from taxation, it cannot create provisions.

Accounting units would debit provisions to costs. Their use, reduction or cancellation are included in revenues. If the reasons for creating provisions pass over, the accounting units are obliged to dissolve provisions in revenues in full. It is only possible to deduct the cost of creating provisions from the tax base, if it has been accounted for in line with the accounting legislation. This is why it is not sufficient if accounting units report the creation, use and dissolution of provisions on the off-balance accounts kept only for the purpose of establishing the income tax base. Expenditures for which a non-profit organization keeping books under the Implementing Regulation No. 504/2002 created provisions are settled preferably from the provisions. It follows that it is useful if the financial resources in assets cover the liability item of provisions. The Amendment No. 2/2009 imposed

a radical tightening of rules for creating provisions for the repair of tangible assets and since 1 January 2009, the condition is to deposit money in the amount of provisions on a separate account before submitting a tax return for the period for which the reserve was created. Under temporary stipulations, the tightening of rules applies only to provisions that were initiated in 2009.

If a reserve is not drawn upon within a period defined by law (for example because the non-profit organization did not have the funds to cover expenditure and the expenditure could not have taken place), the accounting unit is obliged to dissolve the reserve in revenues. A one-off dissolution of provisions can affect the tax base for the relevant taxation period significantly. A non-profit organization is obliged to dissolve the provisions in revenues in the accounting period in which it winds up its operation.

Applying the prudence principle in accounting units that are banks and other financial institutions

Accounting impairments to assets

Banks make impairments to individual asset items in the same way as other business companies. However, they create many more impairments for **receivables from provided loans** that represent a significant portion of the bank assets. Receivable is understood to be the principal including the interest and fees.

In assessing receivables from loans, the quality and amount of receivables security are not taken into account. On the other hand, in making impairments a bank can take into consideration the amount and quality of security of the relevant receivable for example by assigning so-called weight to a certain security type, expressed as percentage.

In connection with the amended **IAS 39 – Financial instruments: Recognition and Measurement** – since 2005 it is possible to use a two-step procedure in the case of individually assessed receivables: the receivables are assessed individually first and then, based on the first assessment, they are subdivided into individual categories. In the next

II: Differences in the analysed aspects of non-profit organizations as compared to business companies

No.	Analysed aspect	Implementing Regulation 410/2009	Implementing Regulation 504/2002
1.a	Creation and use of accounting impairments – relevant cases	In 2010 accounting impairments are made only to receivables, as of 2011 also to other assets	Creation only in line with the Provisions Act, only if the organization makes any taxable income
1.b	Creation and use of accounting impairments – accounting record	Creation under the implementing regulation, i. e. 10% in receivables for each 90 days overdue	In line with business companies but using the gross method
2.a	Creation and use of provisions – relevant cases	Obligation to create provisions under Section 26 of the Accounting Act starting in 2010	Creation only in line with the Provisions Act, only if the organization makes any taxable income
2.b	Creation and use of provisions – accounting record	In line with business companies using the net method	In line with business companies but using the gross method

step, receivables in which a diminution in value has not been identified are included in portfolios and once again checked whether their value in the portfolio has not been reduced. The bank regulation is not so strict for this second step because the amount and types of portfolios are based on each bank's products. However, the homogeneity of receivables needs to be respected, as it is related to the credit risk.

Accounting for receivables in banks is regulated by the *Regulation of the Czech National Bank No. 9 dated 6 November 2002*, as amended, which defines the *rules for assessing receivables from financial activities, creation of impairments and provisions and rules for acquiring certain types of assets*. This Regulation specifies criteria to be taken into account in assessing receivables from financial activities and methods of making impairments to these receivables **following methods contained in IAS 39. Procedures for the assessment of receivables or their classification are not stipulated in the EC law**. Their existence is mentioned only in directives laying down rules for the financial statements.

In line with the above-mentioned Regulation, banks are obliged to classify receivables from loans according to risk of default level into five groups (standard, controlled, non-standard, dubious and unprofitable receivables provided that non-standard, dubious and unprofitable receivables be referred to as risky). In their accounting, banks report separately the **standard receivables** and separately the controlled and risky receivables that are also referred to as **classified receivables**.

As regards *receivables that are insignificant but with the same risk level*, the bank is allowed to pool them in a *portfolio* and to assess them within the portfolio; after this, their decrease in value may never be assessed individually again. In this case of assessing receivables (in portfolio), the bank will have to have fulfilled certain particularities stipulated in the above-mentioned CNB Regulation.

The portfolio approach to individually insignificant receivables is not a duty but an option. The existence of both ways of assessing the depreciation of assets with a possibility for a choice dwells on international accounting standards as well as on the European legislation.

Accounting methods for recording the creation and use of impairments in banks

The accounting method for recording impairments in banks is the gross method of indirect accounting. This means that the creation of impairments is recorded as increased costs and the drawing on or deletion of impairments is credited to revenues. In line with the current enactment, businesses other than banks use the net method for recording the creation and use of impairments in their accounts. We assume that the gross method applied by banks is more transparent than the net method from the accounting point of view as well as in terms of reflection in the accounting reports.

This is likely due to a significantly higher frequency of use and higher amounts as well as due to the importance for the financial activities of banks.

Provisions

Provisions are registered **by the purpose** for which they are created. They represent a special type of external resources; **they are debited to costs**, expressing an internal commitment of the bank. They are not created to cover general banking and other contingent risks; for this purpose there are funds created from profit and other sources.

Provisions are used **mainly in other than financial activities** of banks, for example for repairs of tangible assets like in other business organizations. **In financial activities, the specific impairments mentioned above are applied.**

Accounting methods for recording the creation and use of provisions in banks

The accounting method for recording the creation and use of provisions in banks is the gross method. This means that the creation of provisions is recorded as increased costs and their use (drawing or deletion) is credited to revenues. In line with applicable legislation, businesses other than banks use the net method for recording the creation and use of provisions. The justification of this way for recording the creation and drawing on provisions will be identical with that in impairments.

Applying the prudence principle in accounting units that are insurance companies

Accounting impairments to assets

Insurance companies create impairments to individual asset items in the same way as other business organizations.

What is different in the insurance companies in this respect is the fact that as of 2004 it has been impossible to create impairments to individual asset items, which the insurance companies included in a so-called financial placement.

Accounting method for recording the creation and use of impairments in insurance companies

The accounting method for recording impairments in insurance companies is the gross method of indirect accounting. This means that the making of impairments is recorded as increased costs and the drawing on or deletion of impairments is credited to revenues. The procedure is identical with that used by banks and other financial institutions, contrary to business entities that use the net method.

Provisions

Pursuant to the special legislation on insurance (Insurance Act, Decree of the Ministry of Finance No. 303/2004 implementing the Insurance Act, as amended), insurance companies create a number

of technical reserves on the liability side of the balance sheet, i.e. provisions directly related to the insurance company's subject of business. **The Czech Accounting Standard No. 207 applicable for insurance companies recommends to establish separate accounts for individual technical reserves.**

From the accounting point of view, the technical reserves represent the appraisal of the insurance company's future liabilities following out from its insurance and reinsurance activities. They are presumable or certain to arise but their amount and timing are uncertain. Their amount is defined in such way that at any time the technical reserves must be sufficient for the insurance company to settle its liabilities arising from the insurance policies.

In accounting for the creation and use of these provisions, the insurance companies report their gross amount as well as the share of reinsurers in them.

In line with their line of business, the insurance companies create the following specific (accounting) provisions:

1. Reserves for non-life insurance
2. Reserves for life insurance.

The report on the creation and amount of technical reserves and composition of the financial placement of assets which are derived from technical reserves is **submitted by the insurance company** or reinsurance company to the Ministry of Finance on 30 June and 31 December of each year. Deadline for the submission is 60 days after the stated end date.

Pursuant to Section 27, paragraph 1 C) of the Accounting Act and the Implementing Regulation No. 502/2002, **technical reserves are re-valued at net book value.** Differences in the valuation of technical reserves are reported in the appropriate profit&loss statement row, in which the creation or use of the provision is shown and as a liability in the appropriate row of technical reserve.

If a certain insurance policy (insurance contract) is subject to reinsurance, the relevant reinsurer's share needs to be taken into consideration in creating technical reserves, which has to be accounted for. **Compensation reserve is not included in the reinsurance though.**

In addition to the above-mentioned specific provisions based directly on their line of business, insurance companies create and place to account provisions for other risks and losses. These are reserves for pensions and similar payables, reserve for income tax, reserve for risks and losses, and reserve for restructuring (similarly to normal business companies).

Accounting methods for recording the creation and use of provisions in insurance companies

The accounting method for recording the creation and use of provisions in insurance companies is the gross method. This means that the creation of provisions is recorded as increased costs and their use (drawing or deletion) is credited to revenues. The procedure is identical with that in banks and other financial institutions and different from business companies that use the gross method.

III: Differences in aspects analysed in the financial institutions as compared to the business companies

No.	Analysed aspect	Banks	Insurance companies
1.a	Creation and use of accounting impairments – relevant cases	In a vast majority of cases for receivables from loans (subject of activity)	Same as in business companies – for concrete assets
1.b	Creation and use of accounting impairments – accounting records	Same as in business companies but using the gross method	Same as in business companies but using the gross method
2.a	Creation and use of provisions – relevant cases	Same as in business companies – namely in other than financial activities	In a vast majority of cases technical provisions for life and non-life insurance (subject of activity)
2.b	Creation and use of provisions – accounting records	Same as in business companies but using the gross method	Same as in business companies but using the gross method

SUMMARY

The accounting method for recording **impairments to assets and provisions in financial institutions** (banks and insurance companies) is the gross method of indirect accounting, which is different from the method applied in business entities. This means that the creation of impairments (and provisions) is recorded as increased costs and their use, i.e. drawing or deletion, is credited to revenues. In line with the applicable legislation, business companies (non-financial) use the net method for recording the creation and use of impairments (and provisions) in their accounts. We assume that the gross method applied by the financial institutions is more transparent than the net method applied by business companies both from the accounting point of view as well as in terms

of reflection in accounting reports. The reason is probably a significantly higher frequency of use by these entities and due to the amounts and importance for their principal activities. **Banks** in particular use impairments mainly for receivables from provided loans that represent a significant portion of their assets. **Insurance companies**, in reaction to risks arising from their subject of activity, create provisions with a very detailed structure.

The accounting reform launched in the field of public finance has markedly changed the hitherto method of public administration accounting. It has introduced the accrual principle for selected accounting units (Implementing Regulation No. 410/2009). New accounting methods have been introduced. With respect to the prudence principle, it is the method of creating impairments and provisions. The accounting method of recording is similar to that used in business companies – creation and drawing are reflected only in costs. The method is referred to as a net method.

In non-profit organizations, keeping books under the Implementing Regulation No. 504/2002, the creation of and drawing on provisions are recorded indirectly – by using the gross method. These entities create impairments and provisions only as required by the Provisions Act. In these accounting units, the previous method of creating and drawing on impairments appears to be less expedient. Following the introduction of the Central national system of accounting data primarily collecting accounting records from selected accounting units but also reports from other accounting units we would recommend use of the net method for the creation of impairments and provisions. Other accounting units are namely those that provide public services or in which the state has a capital share. These will submit the financial statement and supplementary data for the preparation of consolidated financial statements of the state. Therefore, it would be useful in the future to introduce for them a similar reporting of the accounting data – i.e. reporting that takes into account the creation of impairments and provisions using the net method.

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Vyhláška č. 502/2002 Sb., kterou se provádějí některá ustanovení zákona č. 563/1991 Sb., o účetnictví, ve znění pozdějších předpisů, pro účetní jednotky, které jsou pojišťovnami.

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