

## THE CONSERVATISM PRINCIPLE IN ECONOMIC MANAGEMENT OF AN INDUSTRIAL COMPANY

Andrea SUŠKOVÁ, Jana BUCHTOVÁ

VSB - Technical University of Ostrava, Ostrava, Czech Republic, EU,  
[andrea.suskova@gmail.com](mailto:andrea.suskova@gmail.com), [jana.buchtova@vsb.cz](mailto:jana.buchtova@vsb.cz)

### Abstract

The paper is based on the specific conditions of industrial manufacturing company, where the conservatism principle significantly affects economic management and decision making. For this reason are specified and explained the different tools of the conservatism principle. Attention is focused mainly on the results of a case study, where they were selected for a period of several years of analysis and modeling of reserves for repairs of fixed assets and provisions against receivables with regard to the impact on net income of the business. Graphical presentation of the results of the case study shows the possibility of successful applications of these methods.

**Keywords:** conservatism principle, provisions, adjustments, profit

### 1. INTRODUCTION

Economic management is mainly based on one of the most important pillars, namely financial accounting. Based on the results it can be evaluated not only the current financial and economic situation of the company management, but also its performance, liquidity and other important indicators of the "health" of the company. Details of financial accounting are used to analyze previous periods, to compare them with the current situation and also they can be used to predict the future development of the company. Therefore, the application of the conservatism principle tools plays an important role in financial accounting. The main objectives of this principle are sensitively and appropriately respond to risks arising from economic decision-making. In other words, if there are facts that might mean in the future impairment of assets, although we do not know exactly when and how extensively, we incline to gradual impairment of assets since the moment we have found out, verified and gained valuable foundation [1].

### 2. DEFINITION OF ACCOUNTING AND TAX PRINCIPLES

Accounting principles can be characterized as a set of rules or principles which are respected by companies in accounting, preparation and presentation of financial statements [6]. Between the basic accounting principles belongs e.g. independence of the accounting period, factual and honest display, the definition of the accounting entity, ban of compensation, stability of methods, balance continuity, defining of the realization moment, business continuity, the conservatism principle and others [5]. Accounting principles for business subject in the Czech Republic, the Act No. 563/1991 Coll., the Accounting, related Decree No. 500/2002 Coll. and Czech Accounting Standards for Businesses.

In § 25, paragraph 3 of the accounting the principle of conservatism is defined as follows: "Accounting entities in the end of balance date sheet are evaluating only the gains that have been achieved and here are taken into account all foreseeable risks and potential losses relating to assets and liabilities and they are known to the balance sheet date and also all impairments regardless, whether it is the result of management accounting period profit or loss "[3]. In other words - the company must report items cautiously in relation to their future economic benefit.

Application of tools of the conservatism principle - in provisions and adjustments - is enshrined in accounting rules. In terms of addressing tax reserves and provisions Act No. 593/1992 Coll. Provisions for the purposes of the determining income tax base. Tax efficiency is subject to the Act No. 586/1992 Coll., The Income taxes act. Provisions represent a source intended to cover future obligations or expenditure for which purpose is known and is likely to occur, but is not sure the amount or the date on which they will arise [2].

According to Czech accounting regulations can create these provisions - provision under special laws, provisions for pensions and similar obligations, provision for restructuring, other provisions, in particular the risk of a loss and, provision for income taxes.

Formed provisions are subject to interpretation inventory at which is assessed the amount and founded ness [2].

Adjustments represent temporary impairment of assets; it is therefore a more realistic value. Their formation occurs when it is showed in the inventory a decrease in market value or fair value of assets. This impairment must be temporary and its validity must be demonstrated.

Adjustments can be formed for - receivables, fixed assets, inventories and short-term financial assets.

Act on Provisions for the purpose of the determining income tax base establishes criteria and conditions for the distribution and creation of tax-deductible adjustments. The correct creation of adjustments for receivables stabilizes the financial indicators and prevents unexpected fluctuations [7].

### 3. CASE STUDY

Significant effect of the application of provisions for repairs of tangible fixed assets and adjustments receivables is vividly demonstrated in the case study of selected an unnamed industrial company. Analysis of the current to economic results of the company was found to have not been made and no provisions or adjustments (or only the minimum amount in some years), although the conditions for their formation occurred. From 2009 to 2013 were results of operations, except for the "crisis" of 2010, progressive tendency (see Fig. 1).

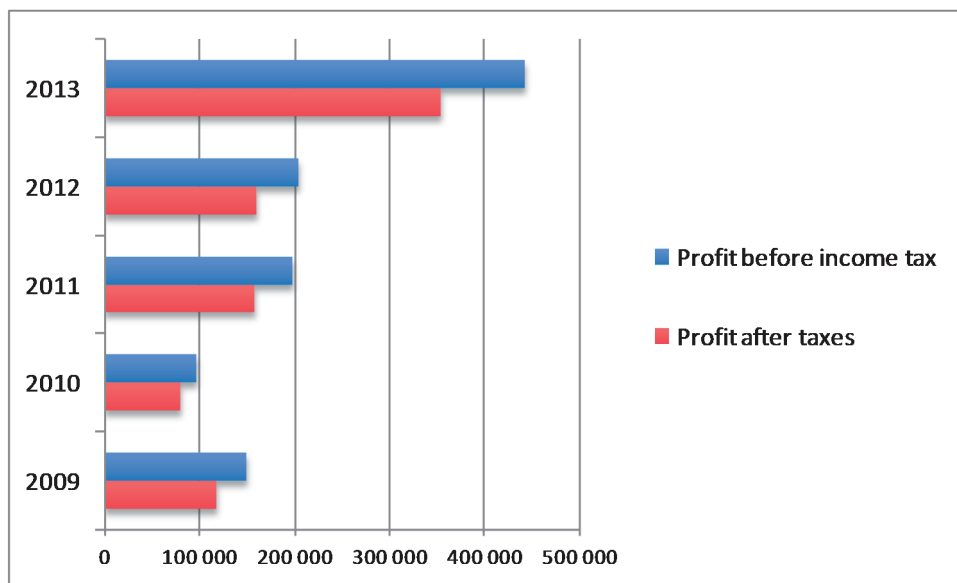


Fig. 1 Development of the Profit 2009-2013 (in thousands CZK)

### 3.1 The provisions for repair tangible fixed assets

The company aims to reconstruct and repair the buildings in the premises of the company. In these object, there will be placed the laboratory, development center, specialized centers and facilities for the staff of these departments. The actual work will start in 2014. While respecting the conservatism principle the company could begin creating provisions for repairs of tangible fixed assets already in 2009. When modelling the formation of provisions we use the repair projects and legislative conditions for this work.

At this moment should be mentioned statutory duty under the provisions of § 10a of Act No. 593/1992 Coll. Provisions for the purpose of determining income tax base that qualifies for tax efficiency justification for the creation of provisions for repairs of tangible fixed assets. These are the establishment of a separate bank account to which the entity postpones funding in the amount of formed provisions [4]. The practical importance of developing legal provisions is at least questionable, since such work has a big impact on reducing the available cash flow of the company. On the other hand; this procedure can prevent equivocal and unsubstantiated tax optimization. However, in the following model situation, we assume only the creation of accounting provisions for repairs of tangible fixed assets.

The total value of repairs was determined amount of 17 250 thousand CZK, for the creation of separate model was used amount of 18 000 thousand CZK, which according to Act No. 593/1992 Coll. Provisions for the purpose of determining income tax base was evenly spread over 5 consecutive Taxable period in the amount of 3 600 thousand CZK from 2009 to 2013. Therefore, in each of year after accounting of this model creation of provisions for repairs of tangible fixed assets there was increase costs, which was reflected in the statement of profit and loss and on the liabilities side in the balance-sheet it increased amount of provisions about its annual formation. This impact is noticeable in the **Table 1**.

**Table 1** The impact of the creation of provisions for repairs of tang. fixed assets 2009-2013 (in thousands CZK)

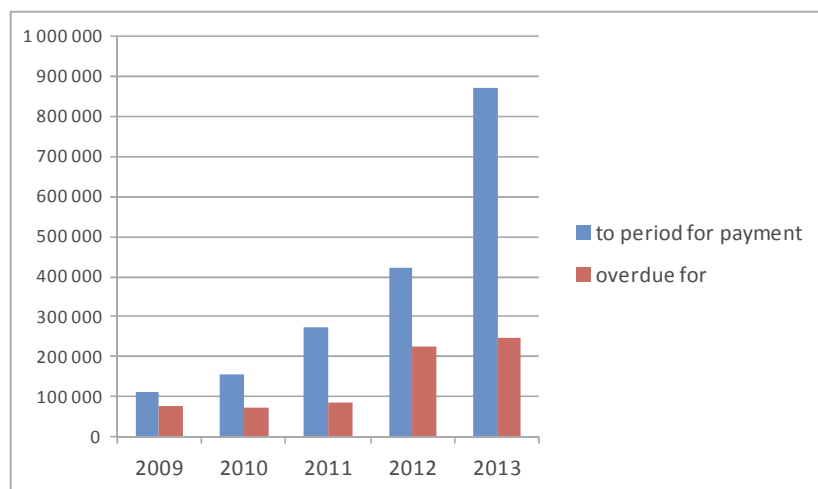
Year	Profit before tax		Reduction of profit before tax	The tax base		Tax obligation		Profit after tax		Reduction of profit after tax
	real state	modeled state		real state	modeled state	real state	modeled state	real state	modeled state	
2009	149 414	145 814	-3 600	142 918	142 918	30 013	30 013	118 797	115 197	-3 600
2010	95 958	92 358	-3 600	74 147	74 147	14 829	14 829	80 026	76 426	-3 600
2011	197 226	193 626	-3 600	189 940	189 940	36 089	36 089	158 145	154 545	-3 600
2012	203 736	200 136	-3 600	222 353	222 353	42 247	42 247	160 674	157 074	-3 600
2013	286 889	283 289	-3 600	453 421	453 421	84 365	84 365	353 263	349 663	-3 600

When comparing the actual situation and the modified results, it is evident that modelling the formation of provisions for repairs of tangible fixed assets will decrease each year accounting profit, but since it is not a tax-deductible expense, does not affect the income tax. Tax liability therefore does not record changes, but it will have significantly influence to the profit after taxation - there will decline.

Thus, we can talk about the good informative value of the financial statements as assets and income are not overstated and liabilities and expenses are understated, all according to the conservatism principle.

### 3.2 Adjustments for receivables

In all regions, customers of the analyzed company had noticeable increase in receivables, which corresponds well with revenue growth in individual countries. The largest growth is evident in countries outside the European Union, mainly thanks to new markets in Asia and South Africa. Despite efforts to minimize the percentage of overdue receivables the company has in evidence relatively high percentage of overdue receivables more than 121 days, which is evident from **Fig. 2**.



**Fig. 2** Analysis of receivables by maturity in the years 2009-2013 (in thousands CZK)

Legislative provisions concerning statutory adjustments, lays down clear rules for their creation. This is especially the previously mentioned Act No. 593/1992 Coll. Reserves for the Purpose of Determining income tax base, which specifies the individual criteria making. Act No. 563/1991 Coll., Accounting, and related accounting regulations addressing the issue of adjustments formed due conservatism, specific rules for their creation should declare an entity unit in its accounting Directive. In light of these criteria were reviewed each overdue receivables at 31. 12. 2009, and in subsequent years, and then were created adjustments for these receivables. When creating adjustments because of conservatism, following criteria were applied. If the end of the maturity date of receivables has been more then:

- 6 months - creation adjustments in the amount of 20 % of the unpaid balance sheet value of receivables,
- 12 months - creation adjustments in the amount of 50 % of the unpaid balance sheet value of receivables,
- 24 months - creation adjustments in the amount of 80 % of the unpaid balance sheet value of receivables,
- 36 months - creation adjustments in the amount of 100 % of the unpaid balance of the receivable.

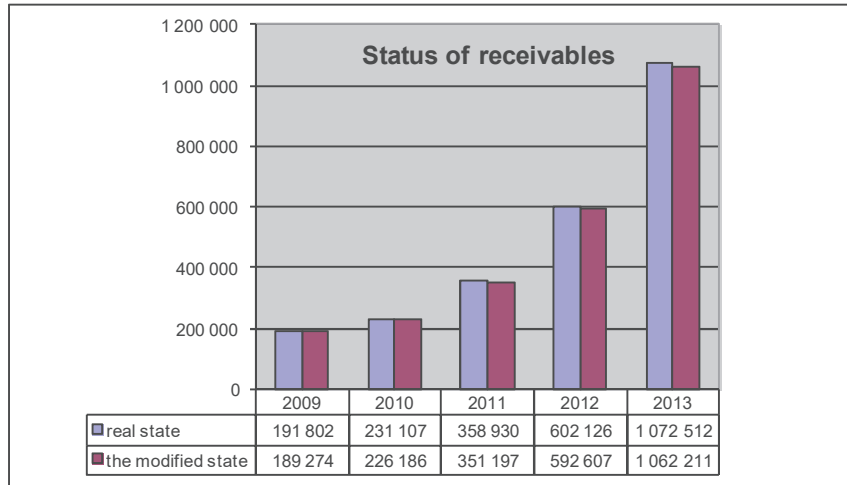
Making accounting adjustments according to the above criteria can be considered very mild, since the normal procedure shows the creation in the amount of 100 % for overdue receivables within 1 year. Collectively, these analyzed data captured in **Table 2**, including the balances of adjustments at the end of the taxable period 2009 - 2013 and transferred to the subsequent period.

**Table 2** Development modeled adjustments 2009-2013 (in thousands CZK)

Year	Balance at 31.12.	Creation adjustment		Use of the adjustment		Balance transfer	Depreciation of receivables
		legal	accounting	legal	accounting		
2009	0	130	2 398	0	0	2 528	305
2010	2 528	1 608	928	33	110	4 921	93
2011	4 921	2 382	477	0	47	7 733	0
2012	7 733	1 390	910	39	475	9 519	316
2013	9 519	1 137	812	0	1 167	10 301	0

After accounting of the modelled creation adjustments it brings us to the modified results of operation, which are significantly influenced by the creation of adjustments. It can be argued that the actual financial statements and results of operations for each year did not correspond to the actual state receivables and there was not

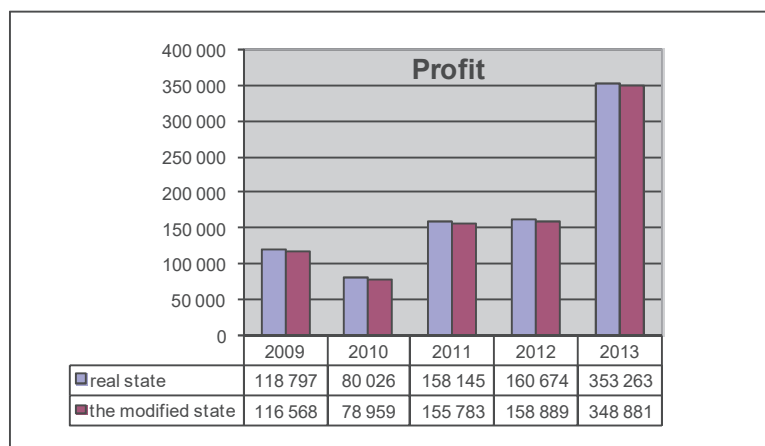
given a true and fair view of the state of the company. Data in real statements are much overstated. Status of receivables in both dimensions is seen in **Fig. 3**.



**Fig. 3** Status of receivables 2009-2013 (in thousands CZK)

#### 4. ANALYSIS OF THE INFLUENCE OF PROVISIONS AND ADJUSTMENTS TO FINANCIAL INDICATORS

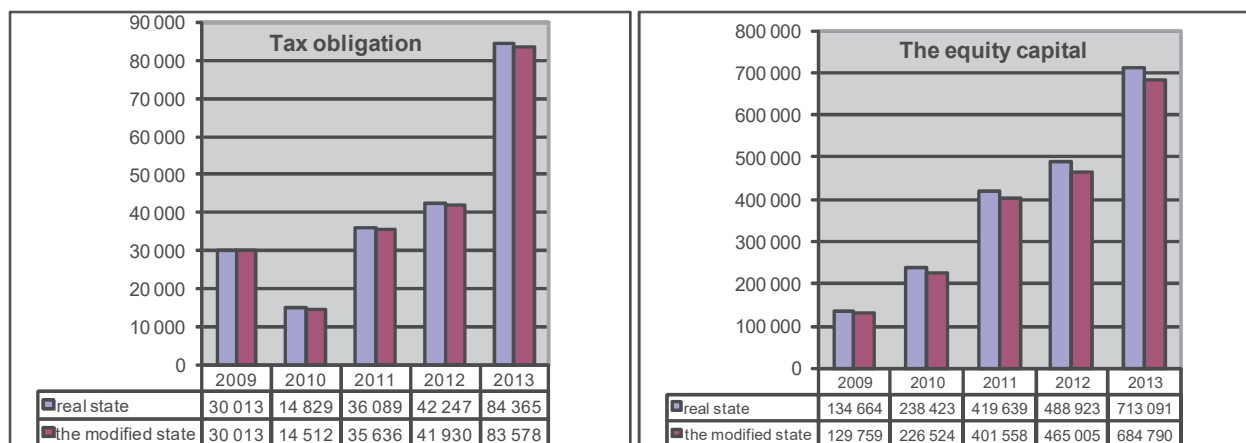
Preparation of the financial statements with both modelled instruments of the conservatism principle - provisions for repairs of tangible fixed assets and adjustments for receivables, we obtain a truer picture of the economic results of the company in the years 2009 - 2013 and also credible basis for an analysis of the tax base and other financial indicators in the implementation of both these tools. The modelled actuality has been incorporated into statements of balance sheets and profit and loss account for the period 2009 - 2013. For clarity and comparisons there are selected only some of the indicators. View of changes in equity values has great explanatory value especially for the owners and creditors of the company. This figure has great impact on other financial indicators and analysis evaluation optimal capital structure and financial and economic health.



**Fig. 4** Profit after taxation influence modeled provisions and adjustments 2009-2013 (in thousands CZK)

Development of profit before taxation, as is evident from **Fig. 4**, is directly proportional to the cost items charged modelled provisions and adjustments. In contrast, the profit after tax is already seeing significant effect of non-deductible expenses, which increase the tax base. In the absence of the application the tools of the

conservatism principle, it could eventually lead to significant oscillations of profit and profit after taxation and incorrect reporting. Another important benefit is the obvious cost savings by reducing the tax obligation for each year. Changes in denominations of tax duty and equity due to the implementation of the conservatism principle tools are evident in **Fig. 5**.



**Fig. 5** Development tax obligation and the equity capital in the years 2009-2013 (in thousands CZK)

## CONCLUSION

Implementation tools conservatism principle in financial accounting and financial management has the task of stabilizing the company's development in the long term and prevent destabilization which could occur by a single application of cost items [7]. This is evident in the case study. The application of these tools puts demands on consistent records of assets and debts and their regular inventory, but also on assessing and monitoring financial indicators. They could be an important clue in predicting potential irregularities and risks arising from the economic and financial management and decision making. Area of reserves and provisions as in terms of reporting and understanding is problematic everywhere in the world, reserves are often subject to so-called creative accounting and there are also some international differences. Therefore, it is necessary to work further on those reserves normally in connection with financial and management accounting and its analyses, with methods and techniques and individually.

## ACKNOWLEDGEMENTS

*The work was supported by the specific university research of Ministry of Education, Youth and Sports of the Czech Republic No. SP2014/81.*

## REFERENCES

- [1] CORNUEJOLS, G., TÜTÜNCÜ, R. Optimalization methods in finance. Cambridge: Cambridge University Press, 2007, 345 p., ISBN 978-0-521-86170-0.
- [2] BUCHTOVÁ, J. Programová učebnice PODVOJNÉ ÚČETNICTVÍ pro podnikatele, MIRAGO, Ostrava, 2004, 298 s., ISBN 80-86617-18-1.
- [3] Zákon č. 563/1991 Sb., o účetnictví.
- [4] Zákon č. 593/1992 Sb., o rezervách pro zjištění základu daně z příjmů.
- [5] PETŘÍK, T. Ekonomické a finanční řízení firmy, Manažerské účetnictví v praxi, Grada Publishing, a.s., 2009, ISBN 978-80-247-3024-0.
- [6] WEYGANDT, J., KIMMEL, P., KIESO, D. Accounting principles. 10<sup>th</sup> ed. Hoboken, NJ: J. Wiley, 2012. 1235 p., ISBN 0470534796.
- [7] MICHAEL, D., EARL, M. Financial accounting: reporting. 6<sup>th</sup> ed. Cincinnati, Ohio: South-Western College Pub, 2003. ISBN 978-032-4149-999.