

RECOGNITION OF PROVISIONS AND THEIR IMPACT ON CAPITAL STRUCTURE AND PROFITABILITY

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Abstract

While assessing the sustainability of an entity the main indicators are its profit and solvency. A profitable entity is able to use its assets effectively and earn an expected return for the owners. In addition to the capital contributed by the owners, entities also raise borrowed capital, as a result of which the liabilities will increase. As a rule, the amount of liabilities and their due dates are known, however, provisions are estimated liabilities, where the outflow of resources is probable but the amount has to be estimated. When provisions are recognised, both liabilities and expenses will increase, thus it will affect the capital structure and profit. An increase in expenses will have an impact on the profit and profitability ratios. A survey on the impact of recognising provisions was performed based on the annual reports of the Top 100 successful companies in Estonia in 2018, which revealed that provisions account for a very small proportion of liabilities. Usually entities have recognised both short-term and long-term provisions, which have been created in relation to environment protection and onerous contracts based on the industry specifics. As provisions account for an average of 5% of liabilities, the impact of capitalising provisions on the capital structure and gearing was minimum. The decrease in profit caused by recognising provisions does not have a significant impact on the return on assets. However, the average return on equity was lower for those companies that had capitalised provisions. Thus, capitalisation of provisions has decreased the solvency of these companies that did capitalise them.

In conclusion, recognising provisions has an impact on different profitability ratios through changes in the capital structure. Therefore, considering the impact of provisions is important while assessing an entity's sustainability.

Keywords: provisions, capital structure, profitability, debt-to-assets ratio, solvency ratio

1. INTRODUCTION

The annual report gives an overview of an accounting entity's performance during a financial year. Financial statements that are presented on time and comply with the requirements increase the entity's credibility. Estonian companies are obliged to perform their accounting in accordance with the International Financial Reporting Standards (IFRS) or Estonian Financial Reporting Standard (EFS). In Estonia annual reports are submitted to the Business Register. An annual report is publicly available to business partners, creditors, investors and also competitors, thus all of them can assess the company's financial and economic position, sustainability, performance, profitability and liquidity or solvency.

The annual report consists of the annual financial statements and the management report [1]. The purpose of preparing and presenting the annual financial statements is to give the user, who has an adequate financial knowledge for understanding the statements, relevant and faithful information about an entity's financial position, performance and cash flows, which would help the user to make economic decisions [1]. One of the obligatory and more important parts of financial statements is the statement of financial position. The statement of financial position shows a company's financial position and lists its assets, liabilities and equity. A liability shown in the statement of financial position is present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits [1]. In the most general way, liabilities can be classified as follows:

- known liabilities, which are shown as current and non-current liabilities in the statement of financial position;

- provisions, which are shown as current and non-current liabilities in the statement of financial position, and the probability of an outflow of economic resources to settle them is over 50%;
- contingent liabilities, which are not shown in the statement of financial position but are disclosed in the notes as the probability of an outflow of economic resources to settle them is below 50%.

The amount at which known liabilities are recognised is usually fixed in an invoice, a contract or another source document, thus the timing and the amount of expenses that will incur while settling the liabilities are known for certain [1]. However, in business there are situations when the incurrence of a future liability is probable but its timing or amount is uncertain. To provide for such probable liabilities in the future, a provision has to be created to ensure the necessary resources to pay for the future expenses. When a provision is created, the profit will decrease and liabilities will increase, which brings along a change in capital structure – the proportion of liabilities will increase and that of equity will decrease. As creating provisions is based on estimation, these decisions may have a significant effect on the entity's profitability and solvency through its capital structure.

The current global healthcare crisis has led to an economic downturn in a large number of countries. The Bank of Estonia has forecast in its overview of economy and monetary policy that under the conditions of the present economic crisis several companies have to accept lower profitability, at least in the short-term. Thus, on the one hand, the fall in companies' profits has been caused by the corona crisis. On the other hand, there is a possibility, especially in case of successful enterprises, that they will not recognise provisions in order to maintain their status quo in the eyes of business partners, creditors and competitors.

Different authors in Estonia have independently researched the formation of capital structure and assessed companies' financial positions but the analysis of the impact of recognising provisions on capital structure has not received sufficient attention. The given article looks deeper into the topic. The article is based on the research problem which deals with the situation where under the circumstances of the current economic downturn companies may not recognise provisions in order to be able to show a higher profit and thus achieve better profitability ratios. As the financial statements of Estonian companies are publicly available, not recognising provisions may be one of the ways to form a desired capital structure and display a better financial position.

The purpose of the article is to get information about the recognition of provisions in the statement of financial position by successful Estonian companies, and to analyse its impact on the capital structure and profitability ratios. To meet the purpose, the following tasks have been set:

- to give a theoretical overview of recognising provisions and its impact on capital structure;
- to analyse and draw conclusions about the impact of provisions on capital structure and profitability ratios.

The outcome of the research reveals which provisions successful Estonian companies have recognised in their financial statements and how important their impact is on the capital structure and profitability.

2. LITERATURE REVIEW

Capital structure has become an incredibly important and intriguing area of theoretical and practical finance [2]. Empirical research has revealed that during an economic boom profit has a smaller influence on company value and the influence is increasing significantly during economic downturns and periods of stagnation [3]. Profit is one of the indicators, which enables to assess a company's success and profitability.

A company's management is obliged to disclose all the material information that affects the accounting entity's financial position, economic performance and cash flows [1]. Information is material for reporting purposes if not disclosing it might affect economic decisions made by the users of the financial statements. Asymmetric information and moral hazard problems between investors and issuers of various securities played an important role also in the financial crisis of 2008 and 2009. Asymmetric

information, inadequate compliance with the requirement of full disclosure will mislead information users so that they would make wrong economic decisions and cause a material mistake while assessing company value based on financial ratios.

One of the important pieces of information that has to be recognised in financial statements is estimated liabilities, i.e. provisions. Provisions are measured based on estimates, which might not always be accurate. Capitalisation of provisions is based either on the management's or other experts' estimate at the probable amount required for settling the liability and its probable timing. While giving estimates one has to rely on the prudence concept in order not to influence the company's financial position in the desired direction. Thus, it is essential that provisions should be recognised and disclosed separately from other liabilities. In the Estonian Accounting Act that was valid until 31 December 2015 the provisions shown in the format of the balance sheet were classified based on the time aspect - short-term and long-term provisions. The amended act enforced on 31 January 2016 adds a content-based classification to the time-based classification of provisions in the format of the balance sheet:

- warranty provision,
- tax provision,
- other provisions.

Other provisions include provisions in specific areas, such as provisions for court cases, onerous contracts, environmental contamination, restructuring, termination of employment contracts, pension or other post-employment benefits. In addition, the Estonian Financial Reporting Standard specifies the recognition of deferred income tax and income tax on dividends as liabilities. As in accordance with the present Estonian tax law not a company's profit for the year but the profit distributed as dividends is subject to tax, companies registered in Estonia do not incur deferred tax liabilities.

In the worst-case scenario, failure to recognise provisions may result in bankruptcy as it happened to the globally known company Mainville Corporation [4]. As the company's field of activity was mining, by the year 1982 its employees had initiated over 50,000 lawsuits because of health deterioration and lack of protective clothing and equipment. Only a year earlier in 1981 the company's financial statements had shown the company as profitable and solvent. Thus, material information that affected the profit had not been disclosed.

In order to identify the impact of provisions on capital structure and economic performance, such financial ratios that include figures from the statement of financial position and from the statement of profit or loss have been chosen for the analysis of the research data.

Capital structure is best described by gearing, which shows how much the company is using borrowed capital for its activities and what is the level of certainty that it will be able to settle its debt obligations. In previous research [5; 6; 7] the debt ratio or debt-to-assets ratio has been used while investigating the relations between the factors affecting capital structure and gearing:

Debt-to-assets ratio = Total debt / total assets x 100

To interpret the debt ratio comparisons with a relevant comparable group or the same company's ratios from previous years as well as some "rules of thumb" are used. What level of financial ratios is considered to be good at any given moment also depends on the credit cycle in the economy – whether banks are willing to give loans or whether they are prudent. As a rule of thumb, the debt ratio should be within the range from 40 to 60 per cent and should definitely not exceed 70 or 80 per cent. In reality, the optimum level can be higher or lower depending on the industry specifics. The best level of debt ratio is the one at the optimum capital structure for the company, i.e. the weighted average cost of capital is the lowest [8]. As it is costly to adapt the debt ratio all the time, companies allow their debt ratios to fluctuate within certain limits and respond to correct it only after the debt ratio has reached the ceiling or the floor of the desired range. In case of borrowed capital, a company has to achieve a reasonable balance between the benefit and the costs of debt financing. [9]. A high level of gearing increases financial risks and finance costs and may decrease solvency.

Capital structure has a material impact also on a company's profitability ratios. A high level of debt has a negative effect on profitability ratios [10]. Recognition of provisions increases expenses and thus affects net profit, which in turn affects the profitability ratios that are related to the net profit. The given research focused on Net Return on Assets (ROA) and Net Return on Equity (ROE) because these ratios are related to the formation of capital structure and the amount of net profit.

The most common ratio to describe the use of total assets is ROA, which shows how effectively a company has used its assets to earn a profit. ROA takes into account a company's net profit and total assets:

$$\text{ROA} = \text{Net profit after taxes} / \text{Total assets} \times 100$$

ROA shows how much net profit each euro invested in the company has earned. It would be preferable to use profit before tax instead of net profit because paying dividends is not related to a company's operating activities but to ensure a better comparability of the given research data, after tax net profit has been used for analysis.

In addition to Return on Assets, it is important for the owners to assess the return on capital contributed by the owners, which is measured by ROE

$$\text{ROE} = \text{Net Income} / \text{Shareholder's Equity} \times 100$$

As a rule, ROE is calculated as net return on ordinary shareholders' equity, as this is the profit that is distributable to shareholders after paying for interests and income tax. Net Return on Equity shows profit per one euro in equity. From the owners' point of view ROE describes a company's effectiveness in increasing shareholders' wealth.

ROE synthesises profitability (Net Return on Sales), the effectiveness of the use of assets (Asset Turnover) and capital structure [11]. In other words, ROE can be observed as dependent on ROA and gearing or debt ratio. ROA is first and foremost affected by net profit and ROE is also affected by Equity to Total Assets.

Capital structure and net profit affect also a company's solvency ratio, which is an important indicator to both creditors and owners because it demonstrates a company's sustainability. The following formula is used to calculate solvency ratio:

$$\text{Solvency ratio} = \text{Net profit after taxes} / \text{Total debt} \times 100$$

Solvency ratio depends directly on capital structure and profit, thus the impact of recognising or failing to recognise provisions is very important. When a provision is created, liabilities increase and expenses increase. Both an increase in liabilities and a decrease in net profit due to increased expenses have a negative effect on the solvency ratio. A declining solvency ratio gives evidence of problems with making payments, which might be a threat of bankruptcy.

3. MATERIALS AND METHODS

Research on the impact of recognising provisions in financial statements was performed based on the information presented in the annual reports of the Top 100 successful companies in Estonia in 2018. The assumption by the researchers is that while companies have recognised provisions in material amounts during an economic upturn, during an economic downturn failure to recognise provisions may be one of the ways to influence the financial results and profitability ratios in the desired direction.

To reach the goal the annual reports of Top 100 successful companies in Estonia in 2018 according to the market leader in the Estonian business media *Äripäev* were researched. The ranking of Top 100 successful companies comprises 500 Estonian companies with the largest turnover. The ranking was compiled based on six economic indicators – turnover for the year 2018, profit for the year 2018, growth in turnover in 2018 (compared to the year 2017), growth in operating profit in 2018 (compared to the year 2017), return on sales and return on assets.

To characterise the companies involved in the research by their activities, the Estonian Classification of Economic Activities has been used, which is the national version of the international harmonised NACE classification. By activities the companies researched were active in wholesale and retail (27%), manufacturing industry (26%), transportation and storage (14%), information and communication (7%), finance and insurance (6%), real estate (4%), vocational, scientific and technical activities (4%), energy supply (3%), agriculture, forestry and fishery (3%), construction (2%). Top 100 companies in 2018 were the least active in the following activities: administrative and supportive activities, art, entertainment and leisure time, health care and social care and water supply.

For financial ratio analysis companies were divided into two groups – the ones in whose statements provisions were recognised and the ones who had not recognised provisions. The aggregated statistical average indicator based on the data of all companies is also presented. The results of the financial ratios calculated during the research are compared to the average aggregations presented by the statistical office of the European Union Eurostat.

4. RESULTS AND DISCUSSION

The companies that participated in the survey applied both the EFS valid for Estonian companies and the IFRS for their accounting and financial reporting purposes. The data collected revealed that 77% of the companies prepared their statements in accordance with the EFS and 23% in accordance with the IFRS. The law firm PricewaterhouseCoopers Legal Baltics performed a comprehensive comparison between the IFRS and EFS and acknowledged that there were no major differences between the principles of EFS and IFRS regarding recognition of provision [12]. Consequently, the research data described below are comparable regardless of the accounting principles used by a company.

In general, the share of provisions in the liabilities of the companies researched was very small. The data of the research reveal that 32% of the 100 companies had shown provisions in their statement of financial position. In the statement of financial position provisions have to be classified as short-term and long-term according to the timing of settling the liability. From these companies that recognised provisions 41% (13 companies) had shown only short-term provisions and 12% (4 companies) had shown only long-term provisions. 47% (15 companies) had shown both long- and short-term provisions.

The financial statements researched were not fully in harmony with the classification of provisions as set in the Estonian Accounting Act because the provisions had been created based on industry specifics. The amounts of provisions were shown as short-term or long-term provisions in the statement of financial position and specified classifications of provisions were disclosed in the notes to financial statements. For example, companies had created provisions for environment protection, termination of mining, allowances for customers, funds for lottery winnings, sales risks, cancellable transactions, covering for the US customs duty liability, obligation of reforestation, waste management, missing CO₂ quotas. In addition, a limited number of companies had created warranty provisions, provisions related to employees (redundancies, termination of contracts), provisions for court expenses and claims for damages. Provisions for environment protection and onerous contracts were most frequently represented.

Analysing the share of the total amount of provisions in the liabilities, it was very low (5%) on average. Three companies had recognised provisions in a remarkably higher amount than the average in their statement of financial position: a company producing rare earth oxides (34% of its liabilities), a public sector institution that deals with arranging lotteries (30%) and the capital's monopolistic water supplier (13%).

As follows, the debt ratio, ROA, ROA and solvency ratios are presented, also the total for EU member states and the statistical averages of Estonia have been presented in comparison.

To describe gearing, the calculated debt ratio has been presented in Table 1. The assumption is that companies that have recognised provisions, should have higher liabilities and a higher debt ratio. This would mean a higher finance risk and decreased solvency for such companies.

	TOP 100 companies total	Companies that have provisions	Companies that do not have provisions
Highest debt ratio	96	86	96
Lowest debt ratio	6	17	6
Average debt ratio	44	44	43

Table 1. Gearing or debt ratio, as percentages

Source: Compiled by authors.

The research revealed that recognising provisions does not have a material impact on the debt ratios of Estonian companies, i.e. the debt ratio of companies that have shown provisions is only by one percentage point higher than that of the others. The difference between companies with the lowest debt ratio was much bigger (difference of 11 percentage points). As the share of provisions was relatively low in the financial statements of the researched companies, the impact of recognising provisions on the average debt ratio was minimum.

In comparison, the average debt ratio in the EU member states was 44.3% and in Estonia 38.3% in 2018 [13].

Considering the generally recommended debt ratio, which could be between 40 and 60 %, it remains in the given range based on both the given research and the EU average. The results lead us to the conclusion that on average companies both in Estonia and in the member states of the EU use more equity and less debt financing.

ROA is the most common ratio for assessing a company's general profitability and based on prior research we can state that Return on Total Assets has a positive and significant impact on company value [14].

Based on the results of the given research the results of ROA show a higher than average profitability in those companies that have recognised provisions as well as in those that have not recognised provisions. Table 2 shows ROA of TOP 100 companies as percentages, based on recognition of provisions in the statement of financial position.

	TOP 100 companies total	Companies that have provisions	Companies that do not have provisions
Highest ROA	84	45	84
Lowest ROA	2	3	2
Average ROA	17	15	18

Table 2. Return on Total Assets (ROA), as percentages

Source: Compiled by authors.

The general conclusion is that recognition of provisions has an impact on the value of ROA. Recognition of provisions has decreased ROA by three percentage points on average. A relatively big difference in case of the highest ROA (39 percentage points) can be explained by the fact that a large number of the companies in the survey were providing a variety of services or dealt with intermediation, where the largest contributor to the profit was the work force and not the assets. Companies that have not recognised provisions, can show a higher net profit, and thus their return on assets was also higher. According to Eurostat (2020) the average ROA was 11.51% in the EU and 9.33% in Estonia [13]. The ROA of TOP 100 by turnover and profit is remarkably higher than the average in the EU or the average in Estonia.

Return on Equity or ROE is directly related to capital structure and profitability as it takes into consideration net profit and the proportion of equity. Based on the formula for calculating ROE, return on equity will increase if the debt ratio increases and if the debt ratio decreases return on equity decreases. Table 3 shows the ROE of the Estonian TOP 100 companies in 2018 classified by recognition of provisions.

	TOP 100 companies total	Companies that have provisions	Companies that do not have provisions
Highest ROE	119	63	119
Lowest ROE	2	5	2
Average ROE	34	29	36

Table 3. Return on Equity (ROE), as percentages

Source: Compiled by authors.

Companies that recognised provisions had a lower ROE by about seven percentage points than companies that did not have provisions. In addition, the results concerning the highest ROE reveal that companies which do not have provisions earn up to 1 euro and 19 cents on each euro contributed by the owners. At the same time, companies which have recognised provisions earn only up to 63 cents on each euro contributed by the owners.

The average ROE was 20.65% in the member states of the EU and 15.12% in Estonia in 2018 [15]. Comparing the data of Eurostat to the results of the given survey, we can conclude that Return on Equity for Top 100 companies was generally higher than the average of the EU member states and significantly higher than the average of Estonian companies.

While analysts reckon that ROE could be at least 2 ROAs or 15 to 20%, it is the case for Estonian Top 100 companies as well.

Cheng et al [16] showed that gearing has a positive relation to return on equity if gearing is less than 0.7 and the relation will change into negative if the level of gearing raises above 0.7. Comparing companies that had recognised and that had not recognised provisions, both groups had a lower level of gearing than 0.7.

The results reveal that a decrease in net income due to recognising provisions has a bigger impact on ROE than a decrease in equity, i.e. in addition to debt ratio other factors affect return on equity as well. The same result was reached by Palusalu [17] in a survey performed in Estonian listed companies.

The clearest impact caused by recognising provisions was revealed by solvency ratio analysis. Solvency ratio relates net profit to liabilities and by recognising provisions the profit will decrease and liabilities will increase, which results in a lower solvency ratio.

The following Table 4 highlights the solvency ratios of the researched companies, expressed as percentages.

	TOP 100 companies total	Companies that have provisions	Companies that do not have provisions
Highest solvency ratio	197	96	197
Lowest solvency ratio	3	5	3
Average solvency ratio	45	33	48

Table 4. Solvency ratio, as percentages

Source: Compiled by authors.

Table 4 shows that companies which do not have provisions have a much better average level of solvency (by 15 percentage points). A significant difference in recognising provisions is expressed by the highest solvency ratio in favour of those companies that have not recognised provisions, thus they can show a higher net profit and lower liabilities. In conclusion, we may state that recognising provisions decreases companies' solvency.

The value of solvency ratio differs in different fields of activity; however, according to US financial analysts a company's financial position is good if the ratio is over 20% [11]. The average solvency ratio in the member states of the EU was 26.0% and in Estonia 24.4% in 2018 [13]. The results of the survey reveal that in spite of the negative effect of recognising provisions on the solvency ratio, the financial position of the companies that had recognised provisions can still be considered good. The remarkably higher results of the survey compared to the average of the EU and the whole of Estonia can be explained by the relatively small share of provisions in the companies participating in the survey and by the fact these were the Estonian Top 100 companies based on their increase in profits.

5. CONCLUSIONS

Provisions are estimated liabilities whose recognition is decided by the company management based on the timing of the liability and the amount required to settle the liability. As creating provisions is based on an estimation, such decisions affect capital structure and net profit, which in their turn affect the company's profitability and solvency.

The above-mentioned research of recognising provisions revealed that only about one third of the companies recognised different provisions in their statement of financial position. Both current and non-current provisions had been shown in the financial statements and provisions for environment protection and onerous contracts prevailed.

While interpreting the results of the survey, we have to remember two aspects. First, the research data were collected from the financial statements of Top 100 of the 500 Estonian companies with the largest turnover, which all had increased their profit in the last year. That explains the higher than average results for all the financial ratios analysed also for those companies that had recognised provisions. Second, while analysing that data it became evident that Top 100 companies had recognised provisions in a relatively small amount. That explains the relatively small differences between the companies that had recognised provisions and the ones that had not.

The main conclusions from the analysis of the selected financial ratios are:

- Recognition of provisions increases the value of debt ratio; however, in the financial statements of the companies researched the proportion of provisions was relatively small and thus the impact of recognising provisions on the average debt ratio was minimum.
- Recognition of provisions decreases the value of ROA, but the expense arising from recognising provisions was minimum and did not have any material impact on the average value of ROA.
- Recognition of provisions decreases the value of ROE and recognition of provisions has a more significant impact on the value of ROE compared to ROA. The high values of return on equity in the companies researched were caused by their high profits.
- Recognition of provisions decreases solvency and here the differences between the companies that had recognised provisions and the ones that had not were brought out most clearly. The companies that had recognised provisions had a remarkably lower solvency ratio.

In summary, we can conclude that during the economic upturn in 2018 Estonian Top 100 companies had recognised provisions in a relatively small amount and if some companies fail to recognise provisions in order to make their profit seem higher during an economic downturn, it will not have any material impact on their capital structure and profitability ratios.

To draw final conclusions about recognition of provisions and its impact the given research should be expanded to research the financial position and performance of the same companies in 2020 and

compare recognition of provisions and its impact on capital structure and profitability ratios during an economic downturn.

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