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SOME CONSIDERATIONS ON ACCOUNTING FOR PAWNSHOPS IN ROMANIA

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***Abstract:** Because of the financial and economic crisis that has affected Romania since October 2008, many people do no longer qualify for the bank loans they need to finance their investments or daily expenses. The alternative could be getting the money by pledging a personal good (especially jewelries) to a pawnshop. According to Romanian laws, pawnshops are non-banking financial institutions that offer monetary loans in exchange for movable assets that are pledged by the customers. They are organized as commercial companies and are supervised by the National Bank of Romania, being recorded into the Entry Register held by this institution. Nonetheless, the pawnshops do not apply accounting rules available for credit institutions, but they prepare the financial statements according to the regulation applied by commercial companies. The paper addresses the peculiarities of the pawnshops' activities in terms of legal, fiscal and accounting aspects. By giving a practical example, the paper emphasizes the application of the specific Romanian legislation, taking into account three different scenarios. The paper discusses the fiscal aspects (mainly the value added tax) that rise from the sell of the items or the cashing of the interest and loan.*

***Key words:** pawn contract, pawned items, loan, fee*

For a better understanding of the example presented later in the paper, we consider of great importance to start with a short introduction of the Romanian accounting history and its current state.

I. ROMANIAN ACCOUNTING SYSTEM

Since early 1990, Romanian accounting has known a continuous process of transformation and evolution. Before the fall of communism in 1989, accounting was dominated by the ideology of the period, being just a tool used by authorities to manipulate data. The model applied was inspired by the soviet accounting which was a normative one based on a general framework that included five sub-frameworks for “five sectors of activity: industry, insurance, banking, trading and industrial offices” [Tiron Tudor, Muțiu, 2007, p. 193] .

After the demise of communism, there was a period of transition between the aforementioned soviet model and the new accounting system based on the French PCG. By 1994, Romania's choice in terms of accounting consisted of an adaptation of the French system. There were little changes of the new accounting model until 2000, when the harmonization with the European directives and the International Accounting Standards

started. This process resulted in the implementation of Order of the Minister of Public Finance no. 94/2001 for approval of the accounting regulations harmonized with the IV EEC Directive and the International Accounting Standards, order used by commercial companies. Additionally, regulations regarding credit institutions, insurance and reinsurance companies and entities admitted to trading on a regulated market were jointly issued by the respective supervisory authorities and the Ministry of Public Finance (the competent authority to issue norms and regulations in the field of accounting in Romania). For smaller companies, a simplified version of the financial statements and of the European directives was introduced through Order of the Minister of Public Finance no. 306/2002.

A new milestone in the evolution of Romanian accounting system was the adoption of Order of the Minister of Public Finance no. 1752/2005 on approval of accounting regulations compliant with the European directives (the previous two orders were repealed in 2006). This was a necessary step taken by Romania in the years prior to its adhesion to the European Union. But this new regulation meant also a restraint of the use of IAS/IFRS by Romanian companies, the international rules being applied only by credit institutions and listed companies for an additional set of consolidated financial statements. Alongside, regulations for credit institutions, insurance and reinsurance companies and entities admitted to trading on a regulated market were made compliant with the European directives.

Currently, the main legislation that regulates accounting and financial reporting in Romania consists of the Accounting Law no. 82/1991 (that includes requirements for the general accounting framework) and Order of the Minister of Public Finance no. 1752/2005 (that covers the financial reporting and other related accounting issues).

II. ACCOUNTING FOR PAWNSHOPS

In any modern economy, the non-banking financial industry plays a significant role because it offers an alternative for the banking services, it multiplies the competition on the loan market and it diversifies the financial instruments. Among other non-banking institutions, such as leasing companies and mutual benefit societies, there are the *pawnshops*.

Despite being organized according to the rules applicable to the commercial companies, the pawnshops are supervised by the National Bank of Romania (as any

financial entity) and recorded into the Entry-Register held by this institution. Their main business activity is *offering monetary loans in exchange for pledged items held for preservation*. “The act of pawning takes place between two parties – a company and an individual – that engage in a transaction based on an agreement between them, each of the party being creditor and debtor to the other at the same time” [Pătruț, Deju, Păcurari, 2005, p. 31]. Basically, the pawnshops lend money to their clients on the security of pledged goods, after signing a contract. They are creditors for the money they lend but also debtors for the pledged items. Their gain consists of the daily fee they cash in during the contractual period of time, fee that is publicly displayed for the customers. When determining the fee, the creditor takes into consideration all operating expenses and the profits expected from the business.

According to the Romanian Civil Code (art. 1685), the pawn is an accessory unilateral real agreement in which the debtor remits tangible or intangible items as collateral. Therefore, the collateral is a real object, much like the mortgage, but the main difference is that the pawn is always based on movable assets that are handed over to the creditor.

The pawnshop is strictly forbidden to use, mortgage, hire, sell, donate or lend the pledged item (except otherwise agreed upon in the pawn contract) and it is compelled to preserve it (without losing or damaging it) and return it to the original owner when the loan and the interest are paid. The rules provide that if the loan is not repaid on the expiration date or if the debtor does not require the extension of the expiration date, the debtor has to pay an extra-fee for the delay. The partial payment of the debt does not end the pledge which is indivisible, being ended only by the full payment of the loan, interests and fees. The lack of payment within the contractual period of time gives the creditor the right to become the owner of the pawned item, offering it for sale or keeping it for own purposes.

In Romania, the pawnshops are regulated through the following legal acts:

- a) regulations regarding the incorporation, organization and operation of pawnshops:
 - Ordinance no. 28/2006 governing certain financial and fiscal measures, published in Monitorul Oficial no. 89/2006;
 - Commercial Companies Act no. 31/1990, republished as subsequently amended and supplemented in Monitorul Oficial no. 1066/2004;
 - Civil Code published in Buletinul Oficial no.1/1981;

- Decree-law no. 2561/1936 for the incorporation of pawnshops, published in Buletinul Oficial no. 264/1936 supplemented through decree-law no. 3621/1937 that were partially repealed by Ordinance no. 28/2006.

Because the majority of the pawned items are golden jewelry and gemstones, it is important to follow the appropriate legislation:

- Emergency Ordinance no. 190/2000 regarding the regime of the gemstones and precious metals in Romania, republished in Monitorul Oficial no. 77/2004 as subsequently amended and supplemented;
 - Government Decision no. 1344/2003 for the approval of methodological norms for the application of Emergency Ordinance no. 190/2000, published in Monitorul Oficial no. 838/2003;
- b) accounting regulation: Order of the Minister of Finance no. 1752/2005 for the approval of accounting regulations compliant with European directives published in Monitorul Oficial no. 1080/2005 including subsequent amendments;
- c) fiscal regulation: Law no. 571/2003 regarding the Fiscal Code published in Monitorul Oficial no. 927/2003 as subsequently amended and supplemented.

The analysis of the application of all these rules is made through an example: a person brings an 18k golden jewelry that the pawnshop assesses it at 1080 RON. The amount of the loan is established at 800 RON, the daily fee 0.6%, and the contract period is 30 days with an additional 30-day grace period explicitly required by the pawner. The extra-fee (after the expiration of the contract or in the absence of its prolongation) is 1% per day (for 10 days). At the expiration of the contract, the pawnshop gets the ownership of the jewelry.

Applying the aforementioned accounting, fiscal and legal rules, the pawnshop's accountant records the following entries into the Journal:

-the offer of the loan: Sundry debtors = Petty cash 800		
-the acceptance of the pledge as an off-balance-sheet asset D: Assets held in custody 1080		
Payment of the loan and fee (<i>case A</i>)		
-the cash-in of the loan and fee: Petty cash = % <u>944</u> Sundry debtors 800 Revenues from 144 sundry activities	-the payment of the fee at the expiration date: Petty cash = Revenues from sundry activities 144 -the cash-in of the loan and the fee after a 5-day extension of the contract : Petty cash = % <u>824</u> Sundry debtors 800 Revenues from 24 sundry activities	-the full payment of the loan 5 days after the expiration date (with the extra-fee of 1%): Petty cash = % <u>984</u> Sundry debtors 800 Revenues from 184 sundry activities
-the hand-over of the pledge after the full payment: C: Assets held in custody 1080		

At the expiration date, the pawnshop and the pawner mutually decide that the pawnshop should take the item on consignment (<i>case B</i>)	
-the selling price: the market value – 1080 lei commercial margin – 10% - 108 lei VAT 19% - 20,52 lei	} 1208, 52 lei
-the taking of the jewelry into consignment: C: Assets held in custody - pawn 1080 D: Assets held in custody - consignment 1080	
-the fee to be received: Sundry debtors = Revenues from sundry activities 144,00	
-the sale of the item in consignment: Petty cash = % <u>1208,52</u> Sale of merchandise 1080,00 Revenues from sundry activities 108,00 Collected VAT 20,52	
-the recognition of the sold merchandise: Goods purchased for sale = % <u>1208,52</u> Sundry debtors 944,00 Sundry creditors 136,00 Commercial margin 108,00 VAT under settlement 20,52	
-the derecognition of the sold item: % = Goods purchased for sale <u>1208,52</u> Merchandise expenses 1080,00 Commercial margin 108,00 VAT under settlement 20,52	
-the taking of the sold item off consignment: C: Assets held in custody - consignment 1080 -the payment due to the original owner: Sundry creditors = Petty cash 136	
Nonpayment of the loan and fee (<i>case C</i>)	
<u>The sale of the jewelry</u>	<u>The keeping of the goods for own purposes</u>
-the selling price: market value – 1080 lei commercial margin–10% 108 lei VAT 19% - 225,72 lei	- the taking of the sold item off consignment C: Assets held in custody consignment 1080
} 1413,72	-the recognition of the goods as working inventory at market value of 1100 lei: Working inventory = % 1100 Sundry debtors 800 Other operating 300 revenues
-the recognition of the jewelry as a balance-sheet asset: Goods purchased for sale = % <u>1413,72</u> Sundry debtors 800,00 Other operating revenues 280,00 Commercial margin 108,00 VAT under settlement 225,72	
- the taking of the sold item off consignment C: Assets held in custody - consignment 1080	
-the sale of the goods: Petty cash = % <u>1413,72</u> Sale of merchandise 1188,00 Collected VAT 225,72	
-the derecognition of the goods: % = Goods purchased for sale <u>1413,72</u> Merchandise expenses 1080,00 Commercial margin 108,00 VAT under settlement 225,72	

On the basis of this example, we like to point out the following things:

a) *accounting considerations*

-the pledged item is not recognized as an asset on the pawnshop's balance-sheet because the latter does not hold its ownership (that is why the pawn is recorded as an off-balance-sheet item). The only exception takes the form of the mutual agreement between

the pawnshop and the pawner for the taking of the pledge on consignment (in which case the item is only temporarily recognized on the balance-sheet). The pledge is recognized as a long-term or current asset only when the pawnshop becomes its owner, that is when the lender may not recoup the loan;

-the receivables created when offering a loan should be recorded as current receivables (using a “sundry debtors” account) and not as long-term financial assets, using the “Other long-term receivables” account, because the loan is a short-term one. We noticed that many pawnshops’ accountants in Romania used the latter account. In our opinion this is a mistake because it does not take into consideration the contract duration;

-the fees cashed in by the pawnshops, although representing the interest of a loan, are not financial revenues because the pawnshops are commercial companies in spite of the fact that they are recorded into the Entry-Register as non-banking financial institutions;

b) *fiscal considerations*

-the interests and fees earned by the pawnshops do not involve the VAT even though the pledged items are redeemed by the debtor (or not);

-when the loan is not paid on expiration date, the pawnshop calculates VAT for the revenues earned from the sale of the goods recognized as balance-sheet assets. If the sold item is one previously taken on consignment, VAT is calculated only for the commercial margin (the creditor keeps for itself the amount of the loan plus the interest plus VAT calculated on the commercial margin and hands over the rest of the money to the original owner. In this situation, the fee earned by the pawnshop consists of the interest of the loan plus the commercial margin and is recognized as “revenue from sundry activities ”.);

-in order to record the VAT calculated for the consignment transactions, the pawnshops keep special books (VAT journal reports) that differ from the other VAT transactions;

c) *legal considerations*

-when offering a loan, the pawnshop completes two copies of a pawn contract which must include: the description of the pawned item, the item’s value, the lending amount, the lending interest rate, the pawn duration and mode of payment, the handling of the pawned goods upon the liquidation of the contract, the rights and obligations of the debtor and creditor, other stipulations. When the pawner requires an extension of the contract, the creditor completes a new contract;

-when receiving the pledge, a pawn ticket is to be completed but most of the pawnshops use a copy of the pawn contract as an acknowledgment for the item taken as pledge. The return of the pawned item to the debtor is made based on the pawn ticket;

-when taking an item on consignment, the pawnshop completes a consignment ticket used for the temporary recognition of the pledge and for its derecognition after sale.

Also, we would like to underline some of the risks that characterize this business. The risks are the ones inherent to any business, such as the credit risk (due to the uncertainty in the debtor's ability to meet its obligations). Some specific risks are: the risk that the pledge is a stolen property (which can be hedged by requiring identification documents from the pawner, following the news about recent robberies in the neighborhood and requesting the police assistance whenever there are suspicions), the risk that the item is counterfeited or fake (against which the pawnshop can fight by hiring specialists to assess jewelry, gemstones, electronics or art). Another risk is that the pawnshop cannot sell the items not redeemed by their original owners (which can be reduced by accepting only items for which there is an active market). Reducing or eliminating those risks depends mainly on the management skills and ...on luck.

III. CONCLUSIONS

The peculiarities of the pawnshops' activities have significant consequences upon their accounting books. The most important aspect is, in our opinion, the fact that although conducting lending activities the pawnshops are financial institutions only because they are recorded into the Entry-Register held by the Romanian National Bank and are supervised by the same entity. But they are organized and they operate as commercial companies. Moreover, their clients are, most of the times, people with financial problems that run out of resources, do not have a bank account or do not qualify for a bank loan. They prefer the simplicity of a pawnshop loan which is a very short-term one (and bears lower interests than ones collected by other informal creditors), it is quick and convenient, does not require co-signers and the failure of payment does not ruin the debtor's credit score (the pawnshops do not report the defaulted loans to the Payment Incidents Register because they have the physical possession of the item and may recoup the loan value through outright sale of the item). These loans generally cover daily expenses and, therefore, there is a great demand for them during the current crisis. The present events turn out to be a blessing for many pawnshops that increase their business and the profits earned from the loans and from the sale of the items not reclaimed by their owners.

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