
Accounting policies and practices applicable for the impairment of assets that generate income other than cash flows

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Abstract

Starting with 2005, at an European level, the European Commission alongside the International Federation of Accountants (IFAC) promoted the implementation of accrual accounting within the public sector and, by default, the shift from cash accounting to accrual accounting, as well as the development of financial statements based on the International Public Sector Accounting Standards (IPSAS). IPSAS' starting point were the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). The requests of the IPSAS Standard 21 "Impairment of Non-Cash-Generating Assets" were drawn up in accordance with this policy. The differentiated practices that can be applied to the public sector in relation to the private sector have led us to the analysis of the solutions suggested by IPSAS 21 precisely to understand and further study the concepts and mechanisms of the depreciation of assets that generate income other than cash flows. Without neglecting the reality of the Romanian accounting practice within the public sector, we will gradually go through the steps of measuring and recognizing the depreciation losses associated with the assets that generate income other than cash flows, owned by the public entities.

Keywords: Public sector, non-cash-generating assets, depreciation loss, recoverable value.

JEL Classification: H83.

To cite this article:

Manea, M.D. (2016), Accounting policies and practices applicable for the impairment of assets that generate income other than cash flows, *Audit Financiar*, vol. XIV, no. 7(139)/2016, pp. 763-770, DOI: 10.20869/AUDITF/2016/139/763

To link to this article:

<http://dx.doi.org/10.20869/AUDITF/2016/139/763>

Introduction

The international financial community recognizes the need for convergence towards a single set of accounting standards IFRS – IPSAS that would provide a common basis for reporting in all countries, with implications on cost reduction as accountants, financial analysts, investors and regulators would no longer need or reconcile or transpose the financial statements from a set of standards to a different set of standards. In terms of Romanian public sector entities' financial reporting, the traditional approach (Tiron-Tudor, 2012) was centred on the budget as a main component of the set of financial statements, compliance with rules and regulations being based on cash accounting principles. In recent decades, to face the continuously changing economic environment, institutions have made the transition to accrual accounting, which ensures transparency, accountability, comparability of data and reports, detailed information on costs useful in facilitating the resources-focused management, while improving the entities' effectiveness and efficiency. It also provides a meaningful assessment of responsibilities pertaining to all the resources managed by the public institution.

Accrual accounting (EC, COM_2013_114 final) is the only information system generally accepted that offers a complete and reliable picture of the economic and financial situation and performance of public administrations, showing a complete picture of an entity's assets and liabilities, revenues and expenses for the period to which the accounts refer to, and at the time the accounts are closed. Being more relevant in economic terms than cash accounting, the current accounting framework for tax monitoring in the EU, SEC 95, is accrual-based. In addition, for budgetary monitoring, lately it was registered a transition to the harmonized European Standards for Public Sector Accounting (EPSAS) due to the need to report complete and comparable fiscal information between EU Member States.

1. State of the art in the field of assets' impairment

Before the harmonization with International Financial Reporting Standards (IFRS), in Romanian accounting it was considered necessary to assess property items at four points in time, namely: recognition, inventory, end-

of-year and derecognition. Value depreciation was resolved using the structures of depreciation/amortization and provisions. To measure the reversible impairment, according to Romanian accounting standards, the focus was on measuring values during the annual inventory.

Valuation of assets (Ristea et al., 2004) during the annual inventory emphasized, especially in practice, the quantitative rather than the qualitative side. During the annual inventory, fixed assets were each measured at their actual or useful value, called the inventory value and determined based on the assets' utility within the entity, their physical condition and the market price. The International Financial Reporting Standards deal differently with the issue of impairment; the term deprival value was induced, with a different meaning than the one commonly used in Romanian practice. It was deemed necessary to recognize an item in the financial statements at an amount that does not exceed its recoverable amount obtained from its use of from trading it on an active market. This is because, in practice, in many European jurisdictions, although there were statutory obligations to compare the assets' carrying amount to their market value, these requirements were not applied rigorously. Furthermore, some jurisdictions, particularly those following the British legal tradition, did not require the disclosure of impairment, unless it occurred on a permanent and long-term basis.

The more rigorous approach of the IFRSs reflects the fact that regulatory authorities have become aware that this was a field neglected by financial reporting. Thus, on the balance sheet date, in accordance with international requirements, the carrying value of fixed assets must be compared with its fair value and value-in-use. If the higher amount of these future values is less than the carrying amount, the difference is recognized as an impairment loss.

The concept of value depreciation was assimilated by the International Public Sector Accounting Standards Board within the International Federation of Accountants (IFAC) from the IFRS practice especially for ensuring a better and more reliable image of an asset's value, on the balance sheet date in the financial statements of public entities. The IPSAS 21 "Impairment of Non-Cash-Generating Assets" provides all the procedures that can be applied to the assets of a public entity with non-cash-generating assets in order to ensure the recognition of potential impairment losses. Therefore, on the balance

sheet date, in compliance with international provisions, the carrying amount of the fixed asset is compared with its fair value and useful value. If the highest of these values is lower than the carrying amount, then an impairment can be identified for the difference between them.

Applying the impairment test is not done randomly and does not involve all the assets of a public entity. It is considered necessary that the public entity tests for impairment when there are *indications that an asset might be impaired*. Also, the requirement that potential impairments be determined for all assets at each balance sheet date is not compulsory, as this would imply indeed a very laborious activity for many public entities. It is, rather, about *the existence of conditions that might suggest an increased risk of impairment to be assessed*. Thus, on the balance sheet date it is necessary to identify those assets that, under the considered conditions, might be impaired. The existence of conditions, or indications, do not necessarily imply an impairment, though the entity will need to analyse the recoverable amount of those respective assets.

Since the impairment test is a complex and very costly process for some entities, when measuring the recoverable value, one will implement **the concept of materiality**. If within the previous years for the asset under analysis there was established *a recoverable value significantly higher than the net carrying amount, and for the elapsed time the indications that the asset has lost its value do not consist in events that lead to the reduction of the difference, then it is not necessary to reassess the recoverable value*.

Example: The local council X owns a building constructed in 1983 meant as an *office building*. In 2013, the building had a fair value, net of selling costs of 75,000 RON, useful value estimated based on the depreciated replacement cost of 80,000 RON, while the net accounting value was 60,000 RON. Since the recoverable value is higher than the accounting value by 20,000 RON, and within the following two years there were no events to lead to the idea that the asset could have registered significant changes of market value, or the useful value, respectively, at the end of the budget year 2015, it is not necessary to reassess the recoverable value of the building.

2. Research methodology

In the process of Romania's accession to the EU, to fulfil the commitments of convergence and implementation of the *acquis communautaire*, the Romanian accounting standard-setters initiated a public accounting reform so that the national legal framework was enriched over time by the implementation of new accounting regulations. To simplify, the public sector accounting regulations were harmonized with those of the private sector in terms of chart of accounts and the structure and content of the financial statements, but the reform process is far from complete. In this context, our intention to identify the extent to which Romanian accounting standard-setters assimilated into national legislation the provisions of IPSAS 21 *Impairment of non-cash-generating assets* generated questions such as: Are the public authorities in Romania prepared to implement IPSAS? Are professional accountants working in Romanian public institutions familiar with concepts such as non-cash-generating assets, the recoverable service amount, fair value etc.?

To answer the above-listed questions we conducted a normative research showing gradually the steps for the measurement and recognition of impairment losses on assets non-cash-generating assets according to IPSAS 21 and the possibility of adopting a common language between the standard and Romanian law.

3. Identifying the non-cash-generating assets from the public sector which can be depreciated

When identifying the depreciated assets, the standard requires a set of potential depreciation indications and suggests that these represent a minimum list of factors that will be taken into account. The entity could identify other depreciation factors besides the ones provided by the standard, as the list is not comprehensive. On a first analysis, one will take into account the signals, the impairment criteria grouped into **external criteria** and **internal criteria**.

The external criteria or indications are mainly the result of ruptures within the technological environment, with a negative impact on the assets' utility into service, on the decrease of utility level as a consequence of new assets

appearing on the market, which perform better, or significant long-term changes that emerged within the legal environment or in the governmental policy with adverse effects on the entity. The internal indications are generated by the wear and tear, or by the decrease of the level of services expected to be provided by the asset, changes that show up in its usage, or a long-term decrease of the request for the assets' services, respectively, with a negative impact on the entity etc. Internal indications refer to all the internal information that leads to the idea that, in the future, the asset's performance will decrease. Out of the two categories of information sources, the external criteria or resources that are outside the entity have an important share and require special attention, since they cannot be influenced by the entity or by its management.

Romanian legislation, harmonized with IPSAS standards, by the Order of the Minister of Public Finance no. 1917/2005 as subsequently amended, does not distinguish between internal and external indications of impairment, but merely lists them in paragraph 1.2.6.

Impairment losses of fixed assets, as: physical deterioration, termination of the demand/need for services provided by a fixed asset, decision to terminate the construction of the asset, asset performance lower than that originally envisaged, changes in technology or legislation. It is not the only situation in which Romanian standard-setters do not approach in detail some of the issues treated and exemplified by the international standard in a rigorous manner.

The possibility provided by IPSAS 21 to choose, in establishing the recoverable value, between two values, is not random. It is considered that the entity can recover the value of its assets through use or capitalization on the market. Nevertheless, the measurement of the two values is a complex process, very costly for some of the entities, based on estimations that belong to the management and have a strong subjective charge, which also reflects on the certainty and credibility of the obtained data.

4. Measuring a recoverable service amount. Certainties and uncertainties

Implementing the impairment test to fixed assets for which, at the end of the reporting period, there are clues

of a potential value loss involves measuring the recoverable service amount. According to the standards, an entity has two evident possibilities of recovering the value of its assets: by capitalizing them on an active market or by using it (as a result of ample debates, which concluded that both the hypothesis encountered on the market and the entities' own modelling do not ensure a complete accuracy; this is why they opted between the maximum of the two aggregates, in compliance with the probable behavior of the management).

As a rule, it is easier to determine the fair value minus the selling costs than the value-in-use. From the definition provided by the standard, the fair value minus the selling costs is the value which can be obtained by willingly selling an asset within a transaction that takes places in objective conditions between the interested parties that are fully informed, from which the concession costs are deducted. Since it is measured on the market, where the seller's offer meets the buyer's offer, the estimation of fair value minus the concession costs is, most of the time, certainly carried out for the entity. The objective of the entity is to identify the fair value on the market of the fixed asset from which it can subtract the costs related to taking it out of use. In the economies characterized by the existence of specialized markets for assets, there will be no significant difficulties since the fair value is relatively easy to estimate for the entity. However, despite the fact that the IFRS/IPSAS frequently use notions like fair value and active market, the reality of the Romanian economy proves that, for the majority of the assets, there are no active markets where this aggregate could be assessed.

However, it is possible to determine the fair value minus the selling costs even if the asset is not traded on an active market. Under these circumstances, the entity will analyse the information it has related to potential past transactions, with similar assets, for which they know the selling prices on the market; likewise, if there are offers made for similar assets and the prices reach approximately close values, they can make an estimation of the net fair value.

Without the intention of drawing a conclusion, in many cases, the notion of fair value only knows a single reality: the market value. This, however, only represents one of the ways of measuring the fair value, the one which ensures the most objectivity since it is based on

information outside the entity, which cannot be, under any circumstances, influenced by it.

Using an assessment technique constitutes an alternative method of measuring value, when there is no price established on the market. The following two approaches can be encountered:

- the first one is the *analogy method* which involves resorting to the market value of a similar asset that presents identical or at least similar characteristics with the asset that is being analysed;
- the second approach implies capitalizing an asset using the *modelling technique*. The method of establishing the value of an asset through analogy or similarity is, from a theoretical point of view, valid, however, in practice, this is difficult to realize, to the extent that the notion of *similar characteristics* is, most of the times, difficult to establish and prove.

Although there is no equivalent in IPSAS for IFRS 13 *Fair value measurement*, according to the established policy of convergence between IPSAS and IFRS, fair value should be estimated in a manner that is consistent with IFRS.

Instead, Romanian law considers that fair value is determined only on the basis of assessments made by professional valuers, members of a professional body in the field. The different approaches in the provisions of IPSAS and Romanian regulations in the field have generated many gaps in the national accounting practice in terms of information held by professional accountants, who will not engage in modelling fair value as long as the standard-setter does not encourage such behaviour, creating an applicability void related to the provisions of IPSAS in the Romanian territory.

However, returning to the measurement of a recoverable service amount according to IPSAS, sometimes it is impossible to determine the fair value minus the selling costs "because of the absence of a basis for a credible estimation of the sum that could be obtained from selling the asset within a transaction carried out in objective conditions between interested and fully informed parties." Under these circumstances, it is mandatory to measure the value in use, which implies estimations based, in the majority of the cases, on subjective values. Additionally, since its size is different for each entity, due to the uniqueness of its models, it has a higher degree of subjectivity and is, likewise, more difficult to validate.

IPSAS 21 states that a non-cash-generating asset's value-in-use is the discounted value of the **potential remaining service** of the asset. The standard provides additional guidance on the following three methods to estimate the potential service remained:

- the net replacement cost approach,
- the restoration cost approach,
- the service units approach.

The cost approach, specific to the valuation standards (ANEVAR, 2015, IE 2, 2012) and endorsed by the provisions of IPSAS would require minimum valuation knowledge on the part of Romanian professional accountants, as well as significant interpretation and estimates. In addition, the technique of modelling the replacement/restoration cost of the service potential of a non-monetary asset is impractical and outside the reach of practitioners in the Romanian public sector, encased between rigid regulations and the lack of vision and commitment with regard to accounting creativity.

5. Recognition and measurement regarding impairment losses from depreciation for non-cash-generating assets

5.1. The impairment loss in the IPSAS 21 version

The purpose of implementing the impairment test and measuring the recoverable service amount is to identify potential impairment losses for the asset that is being analysed and **recognizing** it within financial statements. In the **measurement** of an impairment loss, it is measured the gap between the net carrying amount, which is higher, and the recoverable service amount, which is lower, by following the provisions of paragraph 52 from IPSAS 21 *Impairment of non-cash-generating assets* according to which "if, and only if, the recoverable service amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable service amount. That reduction is an impairment loss".

Example: In the case of a medical equipment with a gross carrying amount of 100,000 RON, accumulated depreciation of 30,000 RON, for which various

hypothesis were analysed regarding the value-in-use, respectively the fair value minus the selling costs; in Table 1 are outlined the consequences of the necessity

(or lack thereof) to recognize an impairment loss, as it follows:

Table 1. The impairment losses - various hypothesis		
Hypotheses	Impairment	The asset's value in the balance sheet
Hypothesis 1		
Net fair value = 80,000 Net fair value > Net carrying amount	The asset is not impaired	70,000
Hypothesis 2		
Net fair value = 60,000 Value-in-use = 65,000 Recoverable value = 65,000	5,000 RON impairment	65,000
Hypothesis 3		
Net fair value = 60,000 Value-in-use = 50,000 Recoverable value = 60,000	10,000 RON impairment	60,000
Hypothesis 4		
Net fair value = 60,000 Value-in-use = 75,000 Recoverable value = 75,000	The asset is not impaired	70,000

Source: Author's processing

The impairment loss thus measured will be recognized according to paragraph 50 of IPSAS 21 "an impairment loss shall be recognized immediately in surplus or deficit". IPSAS 21 stresses, in paragraphs 54 and 69, the necessity of recognizing the impairment loss by debiting an expenses account and by disposing of the impairment loss through crediting a revenues account. However, there is no strict specification regarding the corresponding accounts, but it is mandatory that the **asset's carrying amount be adjusted**.

Example: A public health institution owns a specialized equipment purchased in the year N for the price of 50,000 RON. The equipment was estimated to have a useful life of 10 years. For the period N – N+5, based on internal reports written by the entity, the value-in-use is measured at 16,500 RON. At the end of the year N+5, based on the current market conditions and on some indications according to which the asset might be impaired, a fair value net of selling costs of 18,000 RON was estimated. Applying the impairment test, at the end of the year N+5, the situation is as follows:

Net fair value 50,000 - [(50,000/10 years) x 6] = 20,000 RON;

Fair value minus selling costs = 18,000 RON;

Value-in-use = 16,500 RON.

Recoverable service amount = 18,000 RON.

Since the net carrying amount is higher than the recoverable service amount, an impairment loss of 2,000 RON for the equipment is recognized, according to the IPSAS provisions, by the direct adjustment of the assets account, as it follows:

Asset impairment expenses	=	Plant and machinery, motor vehicles, animals and plantations	2,000 (1)
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The method of adjusting the asset's value partially renounces, for the impaired assets, at the historical cost as a measurement basis. The above-mentioned example used the technique of recording the impairment directly by adjusting the asset's value, by crediting the appropriate asset account. **Applying the impairment test is made, according to IPSAS, at the moment in which the entity decides if it is advisable to maintain its assets in accounting at a historical cost or if the measurement basis needs to change.**

The Romanian practice, however, uses the structure of *impairment adjustments* for recognizing the temporary losses of value, using amending accounts for outlining the impairment, while the assets are maintained at cost in the financial statements. *However, regardless of the method used for registering the loss, the balance sheet value of the impaired asset is the same, and recognizing the value loss through amending adjustments accounts for impairment does not fully suit the reasoning for the recognition and reversal of these accounting structures.* Moreover, recognizing impairment through adjustment accounts involves, in case of a potential sale of the asset, to ignore the corresponding sales earnings and the effect of reversing the impairment.

After the recognition of an impairment loss *“the depreciation/amortization charge for the asset shall be adjusted in future to allocate the asset’s revised carrying amount less its residual value (if any), on a systematic basis over its remaining useful life”* (IPSAS 21, para. 57).

The main consequence of recognizing the impairment loss of an asset is, according to IPSAS, **changing by adjustment the depreciation/amortization of future years, starting from the recoverable value as a new carrying amount recognized in the financial statements for the respective asset.** The depreciable base will now become the recoverable value, which will be allotted for the remaining useful life; similarly, adjusting depreciation/amortization will be carried out if it is necessary to reverse a previously recognized impairment.

5.2. Approaching impairment loss according to the current Romanian regulations

The Romanian accounting system recognizes impairment losses as temporary value adjustments. *The moment of recognizing an impairment loss is the end of the budgetary year.* At this time, the *asset’s net carrying amount* (the carrying value less the depreciation/amortization and the cumulated impairment adjustments) is compared with the *inventory value*, resulted from the inventory process.

Focusing on the inventory value, since it is the result of modelling certain parameters such as: *the usefulness of the respective assets for the entity, their condition, and the market price, respectively*, the obtained aggregate can be considered similar to the recoverable service amount from international practice, which is, ultimately,

an indication of both market value and value-in-use, according to the IPSAS regulations.

In this way, for the assets that show *reversible negative differences* between the inventory value and the net carrying amount, we carry out an adjustment for impairment or loss of value, **diminishing the asset’s value by using the amending adjustment accounts.** If the international accounting practice recognizes the impairment loss through directly by adjusting the assets accounts, according to the Romanian standard-setters the depreciated assets is registered at cost, while amending adjustment accounts are used.

Example: A public institution owns a building for which the following information is known: cost 320,000 RON, accumulated depreciation 120,000 RON, inventory value established at the end of the budgetary year N 175,000 RON.

At the suggestion of the inventory commission, the public institution will recognize a n impairment adjustment for the building in the amount of 25,000 RON as it follows:

Operational expenses regarding the impairment losses for non-current assets	=	Impairment of buildings	25,000 (2)
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If, subsequent to recording of a value adjustment, an additional impairment for the respective asset is noticed, it is mandatory to increase the adjustment. Even though the Romanian regulations do not thoroughly follow the provisions of the international normalizers (IPSAS), using amending accounts for adjusting the elements of temporarily impaired assets and not the direct adjustment of the corresponding assets’ accounts, the result is finally the same, **the adjustment of the asset that is considered to be impaired.**

Conclusions

Any accounting system, no matter how efficient, modern, or convergent with the applicable international accounting standards, will always be perfectible, even if only because of the fact that the economy, on a national and international level, is continuously transforming, subject to new trends and processes, forced to set new

priorities and to answer new challenges that are more and more avant-gardist.

In terms of reflecting the true and fair view, Romanian public accounting will follow the approach initiated at EU level to harmonize national legislation up to a convergence point with the accounting regulations and techniques/treatments proposed by the international standard-setter. This is because we would have a quality accounting referential and a precise framework, in the absence of which there is no competitiveness. In addition, in terms of better tax and budgetary European integration, only a single set of public sector accounting standards for all Member States would allow national budgetary decisions taken to be assessed at EU level. However, this approach requires significant human and financial resources allocations, difficult to implement in

the current precarious conditions of the Romanian public sector.

The issue of reversible impairment of non-cash-generating assets held by public entities involves the use of methods and discounting techniques specific to valuation specialists, the consistent application of professional judgment, modelling and accounting estimates etc., with which Romanian professional accountants are not yet familiar. However, the need to provide relevant information for decision-making will require to align their behavior with the existing international practices. The budgetary impact will be substantial because this approach involves major investments in employee training and equipping the public sector entities with integrated information systems. The ultimate goal is that Romanian regulations comply with the IPSAS standards.

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