

# IMPAIRMENT OF NON-CURRENT ASSETS IN PUBLIC SECTOR ORGANISATIONS

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**Abstract:** The objective of this paper is to present the specific features of non-current assets impairment as an example of the conservatism principle in accounting and valuation through accounting estimates. The paper also reviews key moments of the International Public Sector Accounting Standards related to establishing the recoverable amount of non-current assets in budget entities in terms of their specific nature of assets, which do not generate cash flows on their own. In addition, the rules and requirements applied to assets impairment in Bulgaria have been reviewed in comparison to international practice.

**Key words:** impairment, non-current assets, public sector, IPSAS.

**JEL:** M41.

## Introduction

Public sector entities are primarily concerned with providing public goods and are less frequently involved in independent economic activities, which generate some financial result<sup>1</sup>. Nevertheless, the importance of accurately evaluating their assets and liabilities and presenting them in annual financial statements should not be underestimated.

The objective of this paper is to analyze the theoretical foundations of non-current assets impairment in budget entities. In order to accomplish this objective, we have reviewed the specific features of impairment as a

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<sup>1</sup> The concepts of public sector organizations/entities and budget organizations/entities have been used synonymously in this paper.

demonstration of the precautionary principle and evaluation through accounting estimates and have analyzed existing legislative acts, which regulate the impairment of assets in public sector entities.

### 1. Impairment as an Accounting Category

One of the major accounting principles, which govern the valuation of assets and liabilities, both theoretically and in practice, is the precautionary principle. According to that principle, all potential risks must be valued to avoid overestimating assets and underestimating liabilities. A key requirement which must be observed in order to do this is providing valuations which take into account the real possibility for assets to generate profit, yet do not overestimate them in pursuance of a high corporate public profile, for example. This may be achieved if extreme precaution is employed in the valuation of assets and liabilities, which underlies the conservatism principle in accounting<sup>2</sup>.

Reporting assets and liabilities at their historical cost and laying an emphasis on the precautionary principle is typical of the continental European accounting model. Valuation conducted according to the conservatism principle is considered to 'prevent excessive optimism in terms of the property and financial position of enterprises'<sup>3</sup>. Precaution reflects the expectation that reported net assets will have a smaller value in a future longer period of time compared to their market value. A typical example of compliance with the conservatism principle in accounting is impairment of assets when their original carrying amount cannot be recovered. Western researchers often quote Feltman and Ohlson's definition according to which conservative accounting is an expression of the expectation that the value of net assets is actually lower than their market value in a long-term future perspective<sup>4</sup>.

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<sup>2</sup> See: **Basu**, S. 1997. The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting & Economics* 24 (December): p. 3-37.

<sup>3</sup> **Filipova**, F. i kolektiv, *Prilagane na MSS/MSFO v Balgaria: sastoyanie i rezultati*, Nauka i iekonomika, IU – Varna, 2013, s.190.

<sup>4</sup> See: **Feltman**, G, Ohlson, J. Valuation and clean surplus accounting for operating and financial activities, *Contemporary Accounting Research*, spring,1995, p. 689-731, <http://users.metu.edu.tr/mugan/Feltham%20Ohlson%201995%20valuation%20and%20clean%20surplus%20accg%20oper%20fin%20act.pdf> (01.04.2016)

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Conservative accounting is subject to a lot of criticism especially from representatives of the Anglo-Saxon accounting tradition who are in favor of the opposite view driven by the willingness to present enterprises as more attractive in terms of investment. Some of that criticism relates to the fact that conservatism may result in inadequacy of presented accounting information due to the requirement that enterprises should predict and recognize any possible losses and not recognize any uncertain profits. R. Watts points out that accounting conservatism has led to considerable asymmetry in the verification of profit and loss recognition, which in turn results in long-term understatement of the net assets of enterprises<sup>5</sup>. Other critics point out the fact that when the conservatism principle is applied, a large number of valuations only present estimates of assets and liabilities, which are largely subjective and often incomprehensible to users of financial reporting information.

Accounting theory and practice abound in valuations. One of the leading Russian accounting theorists, Y. V. Sokolov, points out that there are 'six types of valuations according to the subject of valuation, eight types of valuation according to the valuation method employed, and six types of valuation according to the functional purpose of valuation. Together, they constitute a huge domain of potential valuations where an infinite number of valuations may be provided for each entity'<sup>6</sup>. Furthermore, Sokolov highlights the subjective nature of valuation by claiming that 'All valuations which are the result of the purposeful activity of economic entities are actually subjective'. Hence, we may focus on distinguishing between two groups of valuations, those, which are based on materialized economic events and facts (which are conventionally called deterministic valuations) and valuations which reflect the subjective judgment of the valuator about the future utility of an asset (estimates).

Accounting estimates are increasingly employed in contemporary accounting. The accounting balance itself may be defined as presenting a rough estimate of the property and financial position of an enterprise as of

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<sup>5</sup> See: **Watts**, Ross L., Conservatism in Accounting, [http://papers.ssrn.com/paper.taf?abstract\\_id=371820](http://papers.ssrn.com/paper.taf?abstract_id=371820), 11.07.2013, p. 2-3.

<sup>6</sup> **Sokolov**, Y. V. Osnovy teorii buhgalterskogo uchyota. – M.: Finansy i statistika, 2000, s. 206.

a specific moment<sup>7</sup>. In addition, although they are considered to be a reliable valuation, we should not ignore the fact that accounting estimates are the result of uncertainty which is intrinsic to any business activity. They relate to judgments based on the latest reliable information available and often rely on subjective judgments about future cash flows and market values, which might be substantially manipulated. Although valuations are based on the awareness of managers about current events, actual results may differ from the accounting valuations employed.

Typical examples of assets valued through accounting estimates are those specific assets, which are objects of cultural or historical heritage, pieces of art, military equipment, etc. Since these assets do not have analogues and there is not a regular market for them, they cannot be evaluated in a different manner.

The impairment of assets according to existing expectations about their future utility and the subjective judgement of their recoverable amount undoubtedly falls within the scope of accounting estimates. Within the context of the specific nature of estimates, **assets impairment may be defined as a process of providing a regular estimate about the future that is based on predicted or hypothetical events related to the assets of enterprises.**

## 2. Legal Regulation of Assets Impairment in Public Sector Entities

The rules, regulating the impairment of non-current assets as prescribed by the International Accounting Standards and by a number of nationally accepted accounting principles (for instance, US GAAP, CAN GAAP, JAP GAAP, FRS), as well as by the International Public Sector Accounting Standards, are identical in terms of the major aspects of establishing the assets' impaired value and recognizing the losses resulting

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<sup>7</sup> Thus, for example, when employing a specific impairment policy, a subjective balance valuation of long-term assets may be made through different methods of inventory write-off, hence their residual value in the balance sheet will be subjective.

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from such impairment. An asset may be impaired when its recoverable amount falls below its carrying amount. The recoverable amount then exceeds the value of the used asset and its fair value deducted with the selling costs. In other words, when all opportunities of an asset to recover its value in future are exhausted, this asset should be impaired. On the one hand, entities may choose to dispose of such assets by selling them (in this case the fair value is established by deducting selling costs), and on the other hand, impaired assets may continue to generate profit through their performance, in which case, its value in operation shall be established. The higher of both values, i.e. the better alternative, is considered to be the current recoverable amount of the asset. The loss from the impairment of cash-generating assets is the sum by which the carrying amount of an asset exceeds its recoverable amount. On each reporting date, enterprises estimate whether there are indications that a particular asset might be impaired. When such indications are present, entities need to calculate the recoverable amount of assets that will be impaired.

Enterprises whose accounting is based on the International Accounting Standards apply IAS 36 *Impairment of Assets* to impair their non-current assets. In contrast, according to the International Public Sector Accounting Standards, there are two standards applicable to public sector enterprises, i.e. IPSAS 21 *Impairment of Non-Cash-Generating Assets* and IPSAS 26 *Impairment of Cash-Generating Assets*. The provisions of IPSAS 26 *Impairment of Cash-Generating Assets* are somewhat similar to those of IAS 36 *Impairment of Assets*. IPSAS 26 deals with reporting the impairment of all cash-generating assets except for inventories (where IPSAS 12 is applicable); construction contracts assets (IPSAS 11); financial assets which are dealt with by IPSAS 29; investment property measured at their fair value (IPSAS 16); cash-generating property, plant, and equipment measured using a revaluation model (IPSAS 17); deferred tax assets; intangible assets which are measured at their fair value; goodwill; biological assets measured at fair value; non-current assets held for sale and discontinued operations and other cash-generating assets, whose impairment is settled by other IPSAS.

One of the major differences between IPSAS and IAS in terms of non-current assets impairment is that according to the IAS, all assets of an

enterprise generate cash flows in some form, i.e. even assets, which do not generate cash flows themselves are still part of some independent unit which does generate cash flows. Unlike regulations governing market sector entities, the underlying assumption about public sector entities is that non-current assets do not generate cash flows in general since their objective is to provide public goods to society, rather than engage in manufacturing<sup>8</sup>. Therefore, IPSAS 21 *Impairment of Non-Cash-Generating Assets* is a specific standard applicable to the public sector only and does not have an equivalent in the accounting standards applicable to non-public entities. The standard prescribes special rules for establishing the service value of assets when testing them for impairment.

A comparison between IPSAS 21 and IAS 36 helps identify the following differences:

- ✓ IPSAS 21 deals with non-cash generating assets. It prescribes that the service amount of such assets shall be the present value of the assets' remaining service potential determined by applying various approaches.

- ✓ IPSAS 21 requires that impairment tests shall be applied to all individual assets, while IAS 36 states that when individual assets do not generate cash flows on their own, impairment tests shall be applied to the smallest identifiable cash-generating unit to which these assets belong.

IPSAS 21 *Impairment of Non-cash Generating Assets* applies to all non-cash generating assets, except for: inventories; assets arising from construction contracts; financial assets; investment property; non-cash generating property; plant and equipment that is measured at revalued amounts; non-cash generating intangible assets; other assets in respect of which accounting requirements for impairment are included in another International Public Sector Accounting Standard. According to IPSAS 21, the loss from the impairment of non-cash generating assets is the sum by which the carrying amount of an asset exceeds its recoverable service amount. Similar to the impairment of assets in non-public entities and the

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<sup>8</sup> A snapshot of GAAP differences between IPSAS and IFRS April 2013, [http://www.ey.com/Publication/vwLUAssets/IPSAS\\_vs\\_IFRS/\\$File/IPSAS%20vs%20IFRS.pdf](http://www.ey.com/Publication/vwLUAssets/IPSAS_vs_IFRS/$File/IPSAS%20vs%20IFRS.pdf)

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impairment of cash-generating assets, the recoverable service amount is the higher of an asset's fair value less costs to sell and its value in use.

There is a substantial difference when determining the service amount of assets. The service amount of non-cash generating assets is the present value of their remaining service potential. The present value of the remaining service potential of an asset is determined by applying three approaches depending on the availability of data and the nature of the impairment<sup>9</sup>:

1/The depreciated replacement cost approach – under this approach, the present value of the remaining service potential of an asset is determined as the depreciated replacement cost of an asset. An asset may be replaced either through reproduction (replication) of the existing asset or through replacement of its gross service potential. The depreciated replacement cost is measured as the reproduction or replacement cost of the asset, whichever is lower, less accumulated depreciation calculated on the basis of such cost, to reflect the already consumed or expired service potential of the asset.

2/ The restoration cost approach - the present value of the remaining service potential of an asset is determined by subtracting the estimated restoration cost of the asset from the current cost of replacing the remaining service potential of the asset before impairment. The latter cost is usually determined as the depreciated reproduction or replacement cost of the asset whichever is lower.

3/ The service units approach - the present value of the remaining service potential of an asset is determined by reducing the current cost of the remaining service potential of the asset before impairment to conform with the reduced number of service units expected from the asset in its impaired state. The current cost of replacing the remaining service potential of the asset before impairment is usually determined as in the restoration cost approach.

The approach to determining the fair value of non-cash generating assets less costs to sell is similar to that applied to non-public entities and cash-generating assets. The fair value of an asset may be its price in a

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<sup>9</sup> IPSAS 21 IMPAIRMENT OF NON-CASH-GENERATING ASSETS, section 45 - 49 <https://www.ifac.org/system/files/publications/files/ipsas-21-impairme.pdf>

binding sale agreement in an arm's length transaction; the value of the asset on the active market; the value of similar assets on the active market; or the best possible estimate based on reliable information.

On each reporting date, budget entities need to assess whether there are any indications that an asset may be impaired. In terms of the specific nature of public sector entities, the factors, which indicate that certain assets might be impaired are slightly different. In non-public entities, those refer to the reduced capacity of an asset to generate cash flows due to discontinued operation, loss of market share, competitors on the market, physical deterioration of the asset, etc.<sup>10</sup> Research works indicate that in addition to the various objective circumstances related to assets impairment, there are some powerful subjective factors which affect the discretion to impair an asset in non-public entities, such as changes in governance; compensation for unusually high income; managers' stocks in the company; bonus compensations, etc.<sup>11</sup> Financial results may be manipulated in either direction, since impairment is usually recognized in the reported profit or loss during a specific period. For public sector entities, achieving a particular financial result is not a primary objective, as those entities usually consume, rather than generate national income; their operation is chiefly funded by external sources and relates to providing public goods. Hence, the different factors which affect the impairment of assets in such entities.

IPSAS 21 defines two groups of sources of information when assessing whether there are indications that a non-cash generating asset may be impaired – external and internal ones<sup>12</sup>. External sources include:

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<sup>10</sup> MSS 36 Obeztenka na aktivi, para. 12 -14, Mackenzie, B. i dr.. Mezhdunarodni standarti za schetovodstvo i finansova otchetnost: 2014 MSS/MSFO: Komentari i prilozheniya, Wiley i Danimex, 2013.

<sup>11</sup> See: **Zucca**, Linda J.; Campbell, David, A Closer Look at Discretionary Writedowns of Impaired Assets, R.Accounting Horizons; Sep 1992; 6, 3; ABI/INFORM Globalpg. 30, See further: Guler, L. (2007). Goodwill impairment charges under SFAS 142: Role of executives' incentives and corporate governance [PhD dissertation ]. Advance online publication. Texas A&M University Retrieved from <http://proquest.umi.com.ezproxy.aut.ac.nz/pqdlink?vinst=PROD&attempt=1&fmt=6&startpage=-1&ver=1&vname=PQD&RQT=309&did=1394656061&exp=05-05-2016&scaling=FULL&vtype=PQD&rt=309&cfc=1&TS=1304762390&clientId=7961>

<sup>12</sup> IPSAS 21 IMPAIRMENT OF NON-CASH-GENERATING ASSETS, para. 27, <https://www.ifac.org/system/files/publications/files/ipsas-21-impairme.pdf>



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✓ Cessation, or near cessation, of the demand or need for services provided by the asset;

✓ Significant long-term changes with an adverse effect on the entity which have taken place during the period or will take place in the near future, in the technological, legal or government policy environment in which the entity operates;

Internal sources of information include:

✓ Available evidence of the physical damage of an asset;

✓ Significant long-term changes with an adverse effect on the entity which have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, or plans to dispose of an asset before the previously expected date;

✓ A decision to halt the construction of an asset before it is complete or in a usable condition;

✓ Evidence is available from internal reporting that indicates that the service performance of an asset is, or will be, significantly worse than expected. An impairment loss of a non-generating cash asset may be recovered under the following indications:

- resurgence of the demand or need for services provided by the asset;

- significant long-term favourable changes in the technological, legal, or government environment in which the entity operates;

- significant long-term changes with a favorable effect on the entity in the extent to which, or manner in which, the asset is used or is expected to be used.

- A decision to resume construction of an asset that had been previously halted before it was completed or in a usable condition.

- Evidence is available from internal reporting that indicates that the service performance of an asset is, or will be, significantly better than expected.

The International Public Sector Accounting Standards have not been officially approved to be applied to budget entities in Bulgaria, yet.

According to the regulations given by the Ministry of Finance, National Accounting Standard 36, Impairment of Assets, is not applied to accounting in budget entities, either<sup>13</sup>. This is justified with the fact that the concept of the standard focuses on measuring the cash flows, which assets are expected to generate, and hence, due to the nature and specifics of non-budget entities, the literal application of the standard would be of little practical value, except for some individual cases. In addition, the majority of non-financial non-current assets in public sector entities do not generate direct cash flows since they are primarily used to provide public goods and services, whereas public sector revenue is predominantly generated by taxes.

On the other hand, budget entities should observe the general accounting principle that assets cannot be evaluated at amounts, which cannot be recovered. Therefore, the Ministry of Finance requires that an impairment review of non-financial non-current assets should be made at least once every two years. When determining the impairment loss, the fair value of an asset is considered to be its current recoverable amount. It might be:

- ✓ The current price at which a similar asset of the same potential could be sold at economic benefit, or
- ✓ An expert valuation of the sum of expected acquisition costs for an asset at the moment when that asset is unique or has no market analogues.

The regulations given by the Ministry of Finance do not include establishing the service amount as a possible valuation of non-current assets in non-public sector entities. Only a steady decrease in the price of assets could justify their impairment. Temporary fluctuations in prices are not subject to consideration, nor are other sources of information similar to those stated in IPSAS.

Currently, in order to accrue impairment of non-current assets in public sector entities, according to the present chart of accounts for budget entities and the instructions given for its application, account 7801 *Revaluation of non-financial non-current accounts* is debited with the difference between the carrying value of an asset and its recoverable amount,

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<sup>13</sup> DDS 20/2004, <http://www.minfin.bg/bg/page/1039>

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while that difference is credited to a relevant account in group 20 *Non-current tangible assets* depending on the nature of the specific asset.

At the end of the reporting period, entities should close account 7801, *Revaluation of nonfinancial non-current assets*, by crediting it and debiting account 1201 *Changes in net assets during the period*.

### **Conclusion**

We may conclude that non-current assets impairment is an example of accounting conservatism in assets valuation, which renders it possible to present those assets at their real current recoverable amount. By employing the impairment method, assets are presented through accounting estimates based on the economic benefits, which are expected from them. In countries employing IPSAS and considering the specific nature of public sector entities where non-current assets rarely generate cash flows, a special accounting standard is applied which governs the establishment of the service amount of non-cash generating assets. In Bulgaria, in compliance with the regulations given by the Ministry of Finance, the valuation of the recoverable amount of a non-current asset does not involve establishing its service amount. The latter might only be the fair value of an asset as of the moment of testing it for impairment, though this is not always the best assessment of an assets' recoverable amount.

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