

CONSIDERATIONS REGARDING RECOGNIZING AND EVALUATING LOSSES FROM DEPRECIATION OF FIXED ASSETS

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ABSTRACT:

Fixed assets are subject to declines in certain periods when the carrying amount of the inventory value is settled to a lower value provided by accounting. Impairment of intangible assets, tangible assets, tangible assets in progress and of financial ones, is established on financial expenses, at the end of a financial year when doing inventory and it increases, decreases or is cancelled in the next financial year.

KEYWORDS: *fixed assets, depreciation, book value, fair value, inventory value, adjustments for depreciation, International Standards for Financial Reporting.*

JEL classifications: M40, M41

1. Introduction

Evaluation of assets at balance sheet date is carried at cost, minus accumulated depreciation and impairment of adjustments, or revalued amount, this being the fair value at the date of the revaluation minus any accumulated depreciation or any accumulated losses from depreciation. Evaluation of assets at the time of inventory is done at inventory value established by the inventory commission or authorized evaluators, according to the Law. Assets in progress are also, the object of evaluation.

Adjustments of value are the adjustments made to take into account changes made to individual assets value established at the date of the balance sheet, whether or not the change is definitive or not. Negative adjustments of value can be: permanent adjustments, hereinafter referred to as depreciation and / or temporary adjustments referred to as adjustments for depreciation or impairment, according to the permanent or temporary nature of this adjustment.

Recording the impairment or loss of value is carried at the expense of expenditure accounts regardless of their impact on the profit and loss account. At the end of the financial year based on inventory lists we determine the inventory value of assets. Correcting assets and bringing them to the level of inventory value is done, depending on the type of depreciation, either by registering added depreciation, if there is an irreversible impairment or by establishing or supplementing the adjustments for depreciation, in which case there is a reversible depreciation of them.

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2. Research methodology

Our approach aims to bring into discussion the issue of **recognizing and evaluating losses from depreciation of assets**, and we tried to point out some strong elements. The relevance and reliability of accounting information on the appropriate accounting treatment and the international accounting organism, the IASB, placed on its agenda a long term project for accounting depreciation of assets. Thus, the research is on one hand, a rationalization and reconsideration, and on the other, a synthesis and antithesis of ideas found in literature, of regulations developed by various national and international regulatory authorities. This study tried to identify some criteria for recognizing losses from assets depreciation in financial statements.

Also, the presentation and implementation of accounting and fiscal treatments for losses from depreciation and their resumption complete and reunite the research regarding recognizing losses from depreciation, considering that authors do not agree that income and expenses are influenced by them.

For achieving our goals, we used a deductive and inductive constructive methodology to identify the proper accounting and fiscal treatments on recording resumption of losses from depreciation, as a factor that influences, significantly, the entities' performances for acquiring investments, choosing the legal form and the object of activity.

A. 3. International approaches regarding recognition and evaluation of losses from depreciation of fixed assets

IAS 36 „Depreciation of assets” state that a loss from depreciation is registered *if and only if, the retrievable value of an asset is lower than its book value, the book value of an asset must be decreased in order to be equal to its retrievable value*¹.

The loss from depreciation must be registered straight away as income or loss. The Standard also, states an exception if the revaluated amount is in accordance with other standard. Any loss from a revaluated depreciated asset must be treated as a subtraction from revaluation, according to the other standard. IASB² takes into consideration several criteria to recognize losses from depreciation of assets in financial statements:

- ✓ **The permanence criterion** – if one recognizes that the loss from depreciation is permanent.

Followers of this criterion believe that this avoids recognition of temporary reductions of recoverable value of an asset and it is contrary to historic cost system that accounts for future events, taking into consideration that recognizing losses refers to future activities. Also, the depreciation will reflect these future losses throughout the remaining life of the asset. IASB decided to reject the permanence criterion because it is difficult to determine whether a loss from depreciation is permanent. The risk is that by applying this criterion the recognition of a loss from depreciation may be delayed. This criterion is opposed to the basic concept according to which an asset is a resource generating future benefits. Accrual accounting based on costs can not reflect events

1 International Standards of Financial Reporting – IFRS 2013, Bucharest, Editura CECCAR, 2013.

2 International Standards of Financial Reporting – IFRS 2013, Bucharest, Editura CECCAR, 2013.

without reference to future expectations. If the events that led to a reduction in the recoverable value have already occurred, the carrying amount must be reduced accordingly.

- ✓ **Probability criterion** – recognition if it is considered likely that an asset is impaired, meaning whether it is likely that an enterprise will not recover the carrying amount of the asset.

There are two choices:

- using a trigger recognition, based on the value of future cash flows undiscounted and without allocating interest costs.
- recognition that contingent events occur after the Reporting Period, respectively, as a debt and expense recognition, if:
 - future events are likely to confirm that, though, were taken into account all recoveries related one asset was depreciated or a debt has occurred at the balance sheet date; and
 - value of resulted loss can be established reasonably.

IASB rejected this option because¹:

- International Accounting Standard IAS requirements 10 "*Subsequent events*" were not sufficiently detailed and would have been difficult to apply the standard of probability.

- It would have introduced another unnecessary layer of probability. It is true that the probability factors are already entered in the estimates of value in use and also in the requirement that the recoverable amount has to be higher than the fair value minus selling costs and used value.

- ✓ **Economic criterion** – immediate recognition each time when retrievable value is under the book value of the asset.

Accounting recognition takes place each time the retrievable value is lower than the book value.

IAS 36 „*Assets depreciation*” is based on an economical criterion for recognizing loss from depreciation: a loss from depreciation is recognized each time the retrievable value of an asset is inferior to its book value. This criterion has already been used in many International Accounting Standards before IAS 36, such as IAS 9 "*Research and Development Costs*", IAS 22 "*Entities Combinations*" and also in IAS 16 "*Property, Plant and Equipment*".

IASB has considered that an economic criterion is the best criterion for users to provide useful information to assess future cash flows to be generated by the entity as a whole. In estimating the time value of money and also of risks specific to the asset when needed to determine whether an asset is depreciated we considered factors such as the probability or permanent loss from depreciation².

There are differences in the recognition of losses from depreciation, so some authors consider that a loss from depreciation is recognized in the income statement when there is a clear reduction in the potential of services, such as physical damage. Others think that always a loss from depreciation must be recognized in the income statement. The main argument is that a loss from depreciation occurs when there is a reduction in the

1 Ristea M. – coordonator, Accounting for companies, vol. I, Editura Universitară, Bucharest, 2009, p. 298

2 International Standards of Financial Reporting IFRS 2013, Editura CECCAR, Bucharest, 2013

estimated future cash flows. Under IAS 16 even if an asset is revalued or not, amortization is recognized in the income statement, then why treatment for loss from depreciation related to a revalued asset should be different from that of depreciation? Given the differences of opinion, the IASB decided to maintain the accounting treatment used in IAS 16.

In terms of *cash-generating units*, there are authors who support the principle of determining the recoverable value only for an individual asset. It is difficult to identify cash-generating unit at another level than the one of the enterprise as a whole. Losses from depreciation will never be recognized as individual assets in this case. To identify the lowest level of independent cash inflows for a group of assets is necessary to seek professional judgment. A sensitive issue is to determine the cash inflows of any asset or cash-generating unit when affected by internal transfer prices. In this case we must use the best estimate of the future prices that could be obtained in an objective transaction, for estimating both future cash inflows and cash outflows. The Council took a decision regarding the form of the depreciation test for intangible assets with indefinite life span, as follows:

- a) *“an intangible asset depreciation test must be performed annually or more frequently if there is an indication that the asset may be impaired;*
- b) *recoverable amounts of such assets should be valued and the losses from depreciation (and also of reversals of those losses) for those assets should be accounted for in accordance with the provisions of IAS 36 for assets other than goodwill..”¹*
- B. Non- depreciation of an intangible asset increases the importance of testing that asset, to ensure that its carrying amount does not exceed its recoverable amount, and intangible assets must be tested annually or whenever there is an indication of depreciation.

C. 4. Reversal of losses from depreciation for fixed assets

1) 4.1. *Recognition and assessment of a decrease loss from depreciation*

The standard IAS 36 states that *“a loss from depreciation of an asset other than goodwill is reversed if, and only if a change appears in the estimates used to determine the recoverable amount of an asset since the last loss from depreciation was recognized.”²*

The arguments of those opposing the idea of loss reversal have been the following:

- ✓ it contradicts the accounting system based on historical cost;
- ✓ it brings volatility in reported earnings;
- ✓ the result of reversals of losses from depreciation would not be useful to financial statement users. Neither the reversal or revised carrying amount does not have an informative content;
- ✓ result in the implicit recognition of internally generated goodwill;

1 International Standards of Financial Reporting – IFRS Ediția 2013, Editura CECCAR, Bucharest, 2013

2 International Standards of Financial Reporting – IFRS: January the 1st 2011, Bucharesti, Editura CECCAR, 2011 p. B1261

- ✓ reversals of losses from depreciation open the way to abuses and invites to "make-up" practicing;
- ✓ expensive operation in terms of the need to resume subsequent verification of depreciation.

IASB motivates the need to resume losses from depreciation as follows:

- ✓ complies with the conceptual framework and the idea that future economic benefits that were not previously expected had been evaluated as probable;
- ✓ complies with the accounting system based on historical cost as long as resuming does not result in an book value higher than the initial cost minus the depreciation, in the absence of recognizing loss from depreciation.
- ✓ Losses from depreciation are recognized and evaluated based on estimates;
- ✓ It gives users a clue over the potential of future benefits of an asset or group of assets;
- ✓ results of operations will be faithfully reported for the current and future period because depreciation will not reflect a previous loss from depreciation that is no longer relevant.

2) *Standard prohibits the recognition of reversals of losses from depreciation on goodwill. Some authors believe that reversals of losses from depreciation for goodwill should be treated in the same way as reversals of losses from depreciation on other assets, but a rational judgment must be applied regarding specific events, more important than controlling the entity.*

3) 4.2. Accounting and fiscal treatments regarding recording the reversal of loss from depreciation

➤ A company acquires equipment at 28.12.2009 in order to increase production capacity, the purchase price 58.600 lei. The useful life is estimated at 5 years, and the depreciation method used is linear.

At the end of 2012 the company management wishes to know whether the machine is obsolete and uses the services of an external assessor that estimates the value of 23,500 lei for the equipment. Forecasted selling expenses were estimated to 3,500 lei. Estimated future cash flows of the company are 13,600 lei in 2013 and also of 11,800 in 2014. The discount rate was estimated at 12%.

Table no. 1.-Determination of loss from depreciation at 31.12.2012
lei

Annual depreciation for period 2010,2011,2012	11.720
Carrying amount at 31.12.2012	23.440
Fair value minus costs of sell	20.000
Value in use	17.411
Retrievable amount (max 20.000:17.411)	20.000

Loss from depreciation (23.440 lei - 20.000 lei)	3.440
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The company recognizes the loss from depreciation at 31.12.2012 in amount of 3.440 lei

6xx	=	29xx	3.400
“Expenses from adjustments of assets depreciation”		“Adjustments for depreciation of facilities, vehicles, animals and plantations”	lei

➤ At 31.12.2013 the estimated selling price is 12.250 lei, and the selling costs are estimated at 3.300 lei. Treasury flows estimated for 2014 are 11.500 lei, the discount rate is 12%.

The accounting and fiscal treatment at 31.12.2013 will be:

	Lei
Annual amortization for 2013	8.706
Book value at 31.12.2013	8.706
Fair value minus costs generated by selling	8.950
Value in use	10.268
Retrievable value(max 8.950:10.268)	10.268
Favourable difference(8.706 lei – 10.268 lei)	1.562

The book value must not exceed the net book value if it does not recognize any loss from depreciation in 2012. Thus, the book value would have been of 11.720lei if not for the depreciation. The Company will continue to register at income only part of the depreciation ascertained in amount of 3.014 lei. (11.720 lei-8.706 lei).

Reversals of provisions of a loss from depreciation involve the following accounting article:

29xx	=	78xx	3.014
“Adjustments for depreciation		“Income from	lei

of facilities,
vehicles,
animals and
plantations”

adjustments
on
depreciation
of fixed
assets”

4) 4.3. Case study on the application of the accounting and tax treatments for the reversal of losses from depreciation and also of their reversals

➤ *Fair value minus costs generated by selling*

A company has equipment for the production of furniture. At the end of 2013 as there were indications of depreciation, the Company used a valuation expert to determine the recoverable amount to reliably estimate the value in use. The fair value was estimated by the expert at 76,500 lei. The company must bear the costs of removing this property, estimated to cost 4.670 lei value. Spending on packaging to transport safely are estimated at 1,750 lei.

Fair value	76.500
Costs with uninstalling the asset	4.670
Costs with packing the asset	1.750
Fair value minus costs generated by selling	70.080

The carrying amount of the asset is 71 200 lei at 31.12.2013, therefore the company will record a depreciation for this asset.

Explanation	Accounting article	Type of value	Accounting documents
Updating the gross carrying amount of the asset	6xx = 2xx	Fair value minus costs generated by selling	Evaluation report

➤ *The value in use*

One company purchased equipment at 25.05.2010 for 135,500 lei. The useful life is 5 years. The Company applies the straight-line depreciation method. At the end of 2013it is tested for depreciation and is found no indication that the asset may be impaired. The market value of a similar asset is 55.600 lei, the estimated cost for disposal thereof is 6,800 lei. The company expects to achieve the following cash inflows over the useful life of the asset: 2010-42500 lei, from 2011 to 32,000 lei, 2012-28600 lei, 2013-18500 lei. The discount rate is 12%.

Table no.2. – Determining net book value

Year	Input value	Accounting depreciation	Net book value
2010	135,500	13,550	121,950

2011	135,500	27,100	94,850
2012	135,500	27,100	67,750
2013	135,500	27,100	40,650
2014	135,500	27,100	13,550
2015	135,500	13,550	0

Net book value at 31.12.2013	40650
Fair value minus costs generated by selling	48800

Table no. 3. – Determining the value in use

Indicator	2010	2011	2012	2013	Value in use
Estimated cash flow	22,500	19,800	16,300	11,200	
Actual rate 12%	1.12	1.254	1.404	1.572	
Value in use	20,089	15,789	11,610	7,125	54,613

Retrievable value

=

maximum

Net book value at 31.12.2013

40,650

Value in use

54,613

the machine is not depreciated

The company will test for depreciation at the end of 2014.

- ✓ *Accounting and tax treatment for recognizing and evaluating loss from depreciation*

A company that has as main activity the transport of goods purchased at 15.04.2011 three new trucks in the unit cost of 172.872 lei / truck. Company policy is to sell trucks after three years of use. For this it has a contract with a second hand car dealership, which buys them at 45% of cost. At the end of 2012 as a result of the global financial crisis there are indications that the trucks will be depreciated. Cost of sales taxes is estimated at 1,200 lei per truck.

Table no.4. – Straight-line amortization annuities determination

Year	Input value(3 trucks * 172872 lei)	Accounting amortization	Net book value
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2011	518,616	115,248	403,368
2012	518,616	172,872	230,496
2013	518,616	172,872	57,624
2014	518,616	57,624	0

Table no.5. – Determining fair value minus costs generated by selling

	Selling price=45% of purchase cost	Costs generated by selling	Fair value minus costs generated by selling
<i>Determining fair value minus costs generated by selling</i>	233,377	3,600	229,777

Determining retrievable value and establishing loss from depreciation

Retrievable value	=	Maximum
Net book value at 31.12.2012 230,496		Fair value minus costs generated by selling 229,777
Loss from depreciation		
719		

Recognizing loss from depreciation at 31.12.2012:

6xx “Expenses from adjustments of assets depreciation”	=	29xx “Adjustments for depreciation of facilities, vehicles, animals and plantations”
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For the years 2013 and 2014 annual amortization will be calculated according to the new carrying amount or value of 229.777 lei.

Year	Retrievable value	Accounting amortization	Net book value
2013	229,777	172,333	57,444
2014	229,777	57,444	0

At the end of 2013 after applying the depreciation tests no clues for depreciation have been identified.

5. Conclusions

Applying accounting and fiscal treatments for losses from depreciation and revers them should be made professionally, carefully and predictable by the companies 'management, otherwise it could be perceived as a way to smooth the result. Overestimating depreciation when the company has profit influences the result in a negative way, but underestimating it leads to an increase of the result, both cases influence the performance of the entity.

Recent Romanian accounting regulations¹ have brought completions regarding internal and external sources of information based on which we can conclude if there are or not clues for depreciation of fixed assets.

The fact that Romanian accounting regulations regarding the depreciation of reversible value, is still an arid zone, leads to a lack of attractiveness in recording them and thus, not complying with the faithful image principle. At the same time, the fact that we do not supply a methodology to determine these losses of value entails that the way is computed is not reliable, therefor; companies are forced to turn to revaluating assets, a very expensive alternative.

In this context, modelling fair value in Romania represents a prerogative of professionals assessors, which have information and methods spread in the field.

A sensitive issue is the determination of the cash inflows of any asset or cash-generating unit when affected by internal transfer pricing. In this case we must use the best estimate of the future prices that could be obtained in an objective transaction, in estimating both future cash inflows and cash outflows.

An item of assets whose fair value can be reliably measured will be carried at a revalued amount; this being its fair value at the evaluation date minus any accumulated amortization and also of any subsequent accumulated loss of depreciation.

Although many authors recognize the virtues of fair value in financial reporting that is that it provides a better alternative than the historical cost, fair value is characterized by a high bias as a result of estimates and approximations. We consider it necessary still to have more explicit clarification and rules to be able to say that we are in alignment with international standards.

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