Review of International Accounting Standard 36(Impairment of Assets) In Relation to Property, Plant and Equipment

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Abstract

This paper addressed the issue of creation of secret reserve as a result of provision for impairment vis-a-vis recognition of item of Property, Plant and Equipment (PPE) in the financial statements. The main objective of this paper is to develop theory that impairment of assets as provided in IAS 36 would distort information presented in the financial statement. According to postulate of accounting, historical cost is the appropriate basis for initial accounting recognition of all assets acquisition and the cost value should be retained throughout the accounting process. To match the cost of using the assets to the income derived in an accounting year, provision is made for depreciation to account for the usage of the asset. Before the promulgation of IAS 36, fixed assets (non-current assets) net book value is the amount at which assets are recognized after deducting provision for depreciation from the cost of assets. However, upon promulgation of IAS 36, assets are recognized at carrying amount which is historical cost of the asset minus accumulated depreciation and accumulated impairment losses thereon. The complication and complexity involved in the determination of impairment such as identification of the assets that may be impaired, calculation of recoverable amount, value in use and determination of a cash generating unit have made it to be subjective and may not allow for fair representation of the information presented in the financial statement contrary to the provision of IAS 1

Keywords: secret reserve, historical cost, impairment, recoverable amount, value in use, depreciation, cash generating unit

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Introduction

Financial statements are a structured representation of the financial position and financial performance of an organization. The main thrust of financial statements is provision of information about the financial position, financial performance as well as cash flow of an organization that is beneficial to a wide range of users so as to be able to make well informed economic decisions. It is mandatory for the directors to disclose the accounting policy adopted in recognizing the item of Property, Plant and Equipment (PPE). Going by the accounting postulate, historical cost concept holds that cost is the appropriate basis for initial accounting recognition of all assets acquisitions, service rendered or received, expenses incurred, creditors' and owners' interest. It further says that subsequent to acquisition, cost values are retained throughout the accounting process. In the preparation of the statement of income, all the cost associated with the goods or services rendered must be accounted for. To fulfil the matching concept; depreciation is provided for to account for the usage of the assets. That explains why in the statement of financial statement non-current assets, PPE are stated at the net book value. That is, historical cost minus accumulated depreciation. This is adjudged to be the recoverable amount that an entity can recover in the future through depreciation of the item as well as its net realizable value on disposal (IAS 16). The standard went further to distinguish between net book value and carrying amount. Ordinarily, net book value regarding PPE is historical cost less accumulated depreciation. On the other hand, carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation and impairment losses. Impairment is a downward revaluation or a write down while depreciation is the measurement of the decline in value of assets. Therefore, depreciation should not be confused with impairment which is the measurement of the unplanned, extraordinary decline in value of assets. The essential objective of IAS 36 is to ensure that assets are not carried at a figure greater than their recoverable amount. The main objective of this paper is to develop theory that impairment of asset as provided for in IAS 36 will distort the information presented in the financial statement as a result of creation of secret reserve.

Asset impairment

According to paragraph 8 of IAS 36 an asset is impaired when its carrying amount exceeds its recoverable amount. Paragraph 9 of the same standard further stipulated that an entity shall assess at the end of the reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. In assessing whether there is any indication that an asset may be impaired, it is sacrosanct to that the entity should consider, as a minimum the following indication (paragraph 12, IAS 36):

External sources of information

a. During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

b. Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated.

c. Market interest rates or other market rates of return on investments have increased during the period, and those increase are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

d. The carrying amount of the assets of the entity is more than its market capitalization.

Internal sources of information

e. Evidence is available of obsolescence or physical damage of an asset.

f. Significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future.

g. Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be worse than expected.

Determination /calculation of impairment loss

An impairment loss is the amount by which the carrying amount of an asset or a cash generating unit exceeds its recoverable amount.

While it is very straight forward to calculate carrying cost, it is a little bit complicated to determine recoverable amount. This is the main bone of contention as to rationale of recognizing impairment after provision for depreciation has been made to account for the usage of the asset.

IAS 36 devoted as much as 39 paragraphs to the measurement of recoverable amount in addition to another 42 paragraphs on cash generating units. Considering the complication that attended calculation of recoverable amount, a number of simplification is justified. However, no matter how simple the method may be; there are certain complication to be contended with vis –a-vis fair value and value in use. There is no way fair value will not refer to active market. Even in the presence of active market, estimate would have to be made, this is subjective and cannot be relied upon to be valid, accurate and objective.

In addition, determination of value in use is complicated by reference to the following:

I. Estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal.

misapplying the appropriate discount rate to these future cash flows.

The same problem of subjectivity also comes into play in the determination of the value in use. This is against the tenents of financial statements.

Recognition and measurement of impairment losses

After all the subjectivity and complexity, the next is the recognition and measurement of impairment losses because this is the purpose of the entire standard. The requirement of the standard is that if, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. This reduction is an impairment loss. Immediately, an impairment loss should be recognized as an expense in the income statement, unless the asset is carried at revalued amount as stipulated under IAS 16. IAS 36 went further to state that after impairment loss has been recognized, the depreciation charge for the asset should be adjusted to allocate the revised carrying amount, net of any expected residual value on a systematic basis over its remaining useful life. The effect of this is the excessive provision for depreciation and creation of secrete reserve.

Provision and reserve

Provision is the amount set aside out of profit or surplus to provide for any known liabilities of which the amount cannot be determined with substantial accuracy. Hence, depreciation of PPE is nothing but estimate. The actual depreciation will be known when the items of PPE concerned is finally scraped or sold. Hence, provision for impairment loss is a way of making additional provision for depreciation in form of accelerated depreciation which will make the net asset in the statement of financial position to be stronger than what is disclosed in the financial statement. Reserve on the other hand is amount set aside out of profit and other surplus which is not designed to meet liability to exist at the balance sheet date. IAS 36 permits upward review as well as downward review of an asset. This is usually employed to create secret reserve, though not disclosed in the statement of financial position. The resultant effect is that the net asset position is stronger than that which is disclosed in the statement of financial position.

The provision for impairment loss and subsequent reversal is nothing but an attempt to window dress the financial statement thereby defeating the purpose of presenting financial statements.

Conclusion

Accounting postulate holds that historical cost is the best and appropriate accounting method to be applied to financial transaction and preparation of financial statement. The International Accounting Standard No. 1 stipulated that in a situation where there is departure from fundamental accounting concept; the reporting entity must report it in the financial statement. More often than not, this is not adhered to by a reporting entity. The complexity and subjectivity associated with calculation of impairment loss as a step further in matching the usage of assets to the revenue generated in an accounting period has in a way to creation of secret reserve.

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