FUNDAMENTALS AND PRACTICES FOR THE INITIAL RECOGNITION OF THE FIXED ASSETS

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Abstract*: Assets recognition is a new concept, assimilated in the process of harmonisation of the Romanian accounting regulations with the European Directives and the International Standards of Financial Reporting. The international normalizing document does not indicate a measurement unit for the recognition of a fixed asset element, the application of the professional reason for circumstances which are specific to an enterprise assuring the reliability of the criteria accepted by the management. The paper herein proposes the research of the elements specific for the individual and group recognition applicable to the physical fixed assets, in consideration of the international standards, without omitting to take into account the particularities of the Romanian regulations in this domain, with the purpose of creating a synoptic imagine on the group of perspectives, procedures and data specific both to the accounting standards and to the Romanian practice. It can be considered that the identification and the recognition of the parts and of the individual assets of an enterprise represents a process characterised by a high degree of objectivity, paralleled with the situation of the cash generating units, more complex and subjective when applied.*

Keywords*:* fixed assets, IFRS, IAS, criterions recognition, cash generating unit

1. Individual and group recognition – parts and cash generating units

Assets recognition is a new concept, assimilated in the process of harmonisation of the Romanian accounting regulations with the European Directives and the International Standards of Financial Reporting. According to paragraphs 6 and 7 of IAS 16 “Physical Assets”, two criteria must be fulfilled so that a good is recognised as an asset and, respectively, two conditions so that the good considered as an asset to be recognised as a physical fixed asset.

The first *criterion* raises a few problems as the enterprise must estimate the degree of certitude for the flow of future economic benefits based on the records available at the time of the recognition. In order to satisfy this criterion, it is necessary to establish if the patrimony asset shall contributes, directly or indirectly, at the generation of the treasury flows to the enterprise. At the same time, the enterprise must accept both the benefits and the risks in connection to that asset. The future economical benefits incorporate in assets refer to the assets’ capacity, in general, so also to the physical assets, in particular, to contribute, directly or indirectly, to the treasury flow and treasury equivalents to the enterprise. This perspective is explained by the fact that the enterprise uses the assets to produce goods or to supply services, able to satisfy the more and more diversified needs of the clients and consequently they are willing to pay, in cash or in cash equivalents, in order to obtain them, contributing in this manner to the treasury flow of the enterprise. The potential to contribute at the treasury flow can also be represented by the capacity of the assets to reduce cash exits, for instance an alternative process of production (a new technology) that reduces the costs. This potential can be a productive one, which is included in the exploitation activity of the enterprise. Elements such as the physical assets can be purchased for other purposes, respectively for satisfying the law on the safety and protection of the environment. The procurement of such goods, even if they don’t increase directly the future economical benefits of the physical assets can be necessary so that the enterprise obtains future benefits from the exploitation of its other assets.

The second *criterion* of recognition does not raise special problems as both for procurement and for the execution within the enterprise, the procurement cost, respectively the production cost of the asset that has been obtained, is measurable objectively, whereas the documents that justify indubitably the assessment of the efforts made for the procurement of those assets.

The fulfilment of the first *condition* to recognise an asset as a physical fixed asset requires:

- that asset is owned by the enterprise;
- the asset has one of the following destinations: production of goods, supply of services, leasing to third parties, usage for administrative purposes.

The second *condition* for the recognition of the physical fixed asset implies its usage for a longer period of time, and it is easier to fulfil for the fixed assets which are, as a rule, used along several periods.

The recognition criteria and the conditions mentioned above can be represented in a scheme:

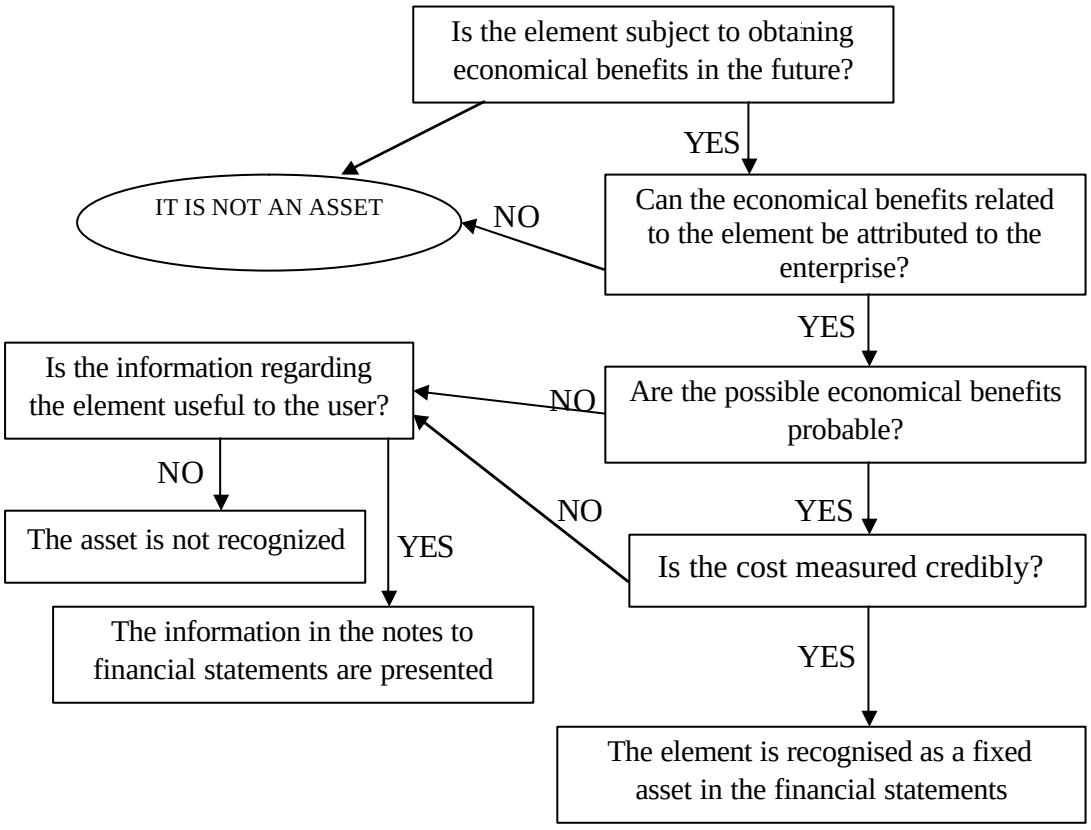

Figure 1. The recognition criteria and the conditions

1.1. Example of the recognition of an individual physical asset

ALFA enterprise (the Beneficiary) has concluded a contract with BETA enterprise (the Supplier) for the design, execution and supply of a one-piece equipment for making platinum-rhodium catalyst sieves. The contract stipulated that the obligations of the supplier are fulfilled when the qualitative parameters specific for the platinum-rhodium products are reached. The equipment is installed and used by ALFA and qualitative faults of the products obtained shall be detected. Shall ALFA enterprise recognise the equipment as physical fixed asset in its financial statements and if so, at what time?

Only after the errors in the design of the equipment are ameliorated and rectified by the BETA supplier, when the qualitative faults of the catalyst sieves shall have disappeared, and the ALFA enterprise shall be able to trade its products at the price level estimated initially, the equipment can be recognised as a physical asset in the financial statements of the beneficiary.

The example presented above highlights the recognition of the *individual physical assets*. The paragraph 8 of the current IAS 16 norm approaches the treatment applicable to the *separated parts and the service equipment*. Where the separated parts and the equipment, through modelling of the enterprise are estimated to be used for more than a period, respectively can be used only in connection with an element of the physical asset, they have to be recognised as fixed assets. All the other situations require the recoding of the parts and of the equipment on the expenses of the period.

Thus, the frameworks used in constructions as permanent equipment without which the main activity cannot be carried out, are considered as physical fixed assets because it can be proved that they are used for more than one period of time. Correspondingly, the parts that a manufacturer of chemical products must install to the operation process for conformity with the environment provisions concerning the production and the storage of hazardous chemical products, can be considered fixed assets as long as the enterprise can neither manufacture, nor sale its products without these parts that improve the manufacturing process.

The International Standards do not specify the *measurement unit* for recognising an element as a fixed asset, applying the professional reason for specific circumstances of an enterprise assures the flexibility of the criteria admitted by the management. It can be considered as appropriate to collect all the elements which are insignificant individually, such as prototypes, tools and dies, applying the criteria of adding value. Identifying and recognizing the parts and the individual assets in an enterprise represents a process characterised by a high degree of objectivity, parallel with the situation of the cash generating units, much more complex and subjective when applied. In practice there are situations when the first criterion for the recognition of assets cannot be fulfilled because the economical benefits generated by the *individual asset* are not, most of them, independent of the cash inflows of other assets or groups of assets.

1.2. Cash generating unit

The enterprise shall identify and recognise *the smallest group of assets that include the individual asset* and generates treasury cash inflows from continuous use, inflows that are mostly independent of the treasury cash inflows from other assets or group of assets when the first criterion of assets recognition is not fulfilled. The solution recommended by IAS 36 "Assets depreciation" to group the assets to whom we cannot refer independent treasury flows from those from other assets or groups of assets, in an group able to generate such autonomous flows has determined the notion of cash generating unit that shall serve as a calculation base for assets depreciation.

According to paragraph 6 of IAS 36 *"a cash generating unit is the smallest identifiable group of assets that generates cash inflows largely independent of the treasury cash inflows from other assets or groups of assets*".

Although in practice, especially in the Romanian practice, the identification of independent cash inflows fro a group of assets shall be difficult and most of the times subjective, still, the cash generating units are, actually, the assets that put together help generating the treasury cash inflows.

The autonomy of a cash generating unit is defined starting with the existence of a market for selling its products, even if their dedication can be carried out for other units of the enterprise, the possibility to sell to third parties is a sufficient condition for the recognition, as stated in paragraph 71 of IAS 36 *"even if the production of an asset or group of assets is used, partially or totally, by other units of the enterprise (for example, the products in an intermediate stage of production), the assets or the group of assets form a separate cash generating unit, if the entity could sell this production on an active market. This is a result of the fact that the asset or the group of assets could generate independent cash inflows, mostly cash inflows from other assets or group of assets. "*

Although, theoretically speaking, by creating cash generating units we can asses possible losses from depreciation of assets that do not generate independently cash inflows, a new problem appears: *the grouping/ regrouping conditions of individual assets in cash generating units*. The process is subjective by nature (depending on the reason) and can lead to a series of abuses that can

restrict the amount of possible depreciations that are to be recognised, regrouping those fixed assets for which there are indication of loss in value with others for which the difference between the net accounting value and the reclaimable value is significant enough and can compensate possible depreciation of the former. At this level, the IAS 36 norm allows a large action space meant to assure that level of grouping of individual assets, specifying that CGU must be determined and modelled from one period to another through actions of the decision-making structures of the enterprise; we can mention here the way in which the management monitors the operations – by type of products, activities, workstations, districts or regions. As we cannot ignore the impact of individual assets management, from one period to another in cash generating units, regarding the level of depreciation to be written down we propose the following situation.

Example:

To explain the phenomenon we have developed the case of a company that manages three points of sale and for which we have images three working hypothesis:

a) each point of sale generates cash inflows independent from the others;

b) points of sale 1 and 3 generate together the cash inflows (the clients of point of store 1 also buy from the point of sale 3);

c) the three points of sale are subject to a common marketing policy, the management is global, the cash inflows are independent. In order to carry out our example we consider a annual inflation rate of 3%, respectively a discount rate of the inflows of 9% as follows:

Year	Inflation	Discount
	3%	9%
1	1,0300	0,9174
2	1,0609	0,8417
3	1,0927	0,7722
4	1,1255	0,7084
5	1,1593	0,6499

Presenting the three points of sale and establishing the loss caused by discounts when each point of sale generate cash inflows independently

Balance sheet point of sale 1 - m.u. -

Fixed assets	Gross value	Depreciation	Net values
Goodwill	80.000	12.000	68.000
Constructions	150.000	30.000	120.000
Technical installations	120.000	48.000	72.000
Tools	35.000	13.000	22.000
Total	**385.000**	**103.000**	**282.000**

Discount of the cash inflows for point of sale 1 - m.u. -

Year	Cash inflows without discount	Inflation rate	Cash inflows after inflation	Discount factor	Cash inflows after discount
1	45.000	1,0300	46.350	0,9174	42.521
2	45.000	1,0609	47.741	0,8417	40.184
3	45.000	1,0927	49.172	0,7722	37.971
4	45.000	1,1255	50.648	0,7084	35.879
5	135.000	1,1593	156.506	0,6499	101.713
Total	**315.000**	**-**	**350.417**	**-**	**258.268**

Synthesis point of sale 1

Net accounting value	282.000
Just value minus selling costs	270.000
Use value without discount	350.417
Use value with discount	258.268
Reclaimable value	270.000
Value depreciation	12.000

Balance sheet point of sale 2 - m.u. -

Fixed assets	Gross value	Depreciation	Net values
Goodwill	80.000	12.000	68.000
Constructions	240.000	24.000	216.000
Technical installations	130.000	108.000	22.000
Tools	90.000	57.300	32.700
Total	**540.000**	**201.300**	**338.700**

Discount of the cash inflows for point of sale 2 - m.u. -

Year	Cash inflows without discount	Inflation rate	Cash inflows after inflation	Discount factor	Cash inflows after discount
1	70.000	1,0300	72.100	0,9174	66.145
2	80.000	1,0609	84.872	0,8417	71.437
3	75.000	1,0927	81.953	0,7722	63.284
4	80.000	1,1255	90.040	0,7084	63.784
5	110.000	1,1593	127.523	0,6499	82.877
Total	**415.000**	**-**	**456.488**	**-**	**347.527**

Synthesis point of sale 2

Net accounting value	338.700
Just value minus selling costs	400.000
Use value without discount	456.488
Use value with discount	347.527
Reclaimable value	400.000
Value depreciation	-

Balance sheet point of sale 3 - m.u. -

Fixed assets	Gross value	Depreciation	Net values
Goodwill	100.000	15.000	85.000
Constructions	130.000	26.000	104.000
Technical installations	140.000	84.000	56.000
Tools	80.000	50.000	30.000
Total	**450.000**	**175.000**	**275.000**

Discount of the cash inflows for point of sale 3 - m.u. -

Year	Cash inflows without discount	Inflation rate	Cash inflows after inflation	Discount factor	Cash inflows after discount
1	40.000	1,0300	41.200	0,9174	37.797
2	45.000	1,0609	47.741	0,8417	40.184
3	60.000	1,0927	65.562	0,7722	50.627
4	65.000	1,1255	73.158	0,7084	51.825
5	95.000	1,1593	110.134	0,6499	71.576
Total	**305.000**	**-**	**337.795**	**-**	**252.009**

Synthesis point of sale 3

Net accounting value	275.000
Just value minus selling costs	230.000
Use value without discount	337.795
Use value with discount	252.009
Reclaimable value	252.009
Value depreciation	22.991

Synthesis hypothesis a) – the three points of sale represent independent cash generating units, the adjustment for reducing the value shall be carried out for each of them, without the possibility to compensate as in the following table:

CGU	Net accounting value	Just value	Use value	Reclaimable value	Difference	Value adjustment
Point of sale 1	282.000	270.000	258.268	270.000	- 12.000	12.000
Point of sale 2	338.700	400.000	347.527	400.000	61.300	-
Point of sale 3	275.000	230.000	252.009	252.009	- 22.991	22.991

Establishing the losses from depreciation in the version when the points of sale 1 and 3 are regrouped in one cash generating unit, the point of sale 2 generated the independent cash inflows

CGU	Net accounting value	Just value	Use value	Reclaimable value	Difference	Value adjustment
Point of sale 1+3	557.000	500.000	510.277	510.277	-46.723	46.723
Point of sale 2	338.700	400.000	347.527	400.000	61.300	-

We can observe that the amount of the CGU depreciation formed by the points of sale 1 and 3 is larger with 11.732 m.u. than the one obtained from adding the value adjustments for the points of sale 1 and 3 when we consider them as independent cash generating units. This difference results from the method used for measuring the value losses.

Establishing the depreciation losses when the three points of sale are subject to a common marketing policy, the management id global, the cash inflows are dependent.

If the three points of sale are comprised in a sole cash generating unit, we shall obtain the following situation:

CGU	Net accounting value	Just value	Use value	Reclaimable value	Difference	Value adjustment
Point of sale 1+2+3	895.700	900.000	857.804	900.000	42.196	-

This hypothesis does not lead to the recognition of a value loss by adjusting the value of the assets that are component part of the larger cash generating unit. The three work hypotheses allow us to observe the incidence of the grouping level of assets in a specified cash generating unit on the amount of the value loss accountable at the end of the fiscal year, starting in our example from the absence of a value loss until the recognition of a value of 46.723 u.m.

The recovery degree of the assets in a CGU has a significant impact on the accountable value depreciations and consequently on the dimension of the result of an enterprise.

1.3. Parts and components of physical fixed assets

Going back to the individual fixed assets, the new IAS 16 standard "Fixed assets" allow their recognition by *parts* and *components* if it can be proved that those elements have different periods or rhythms of use from those of the fixed assets as an group or their require the replacement on regular time intervals.

The recognition of fixed assets on components implies the settlement at least of the following problems:

- when regrouping is required, *dividing* the structure on,
- the two categories of components identified in the normalizing document,
- methodology to determine the components,
- the practical means to apply the recognitions on components.

1.3.1. The necessity to regroup the fixed assets based on component parts

An group grouped on components is regrouped and is recognised if in the structure of the group there are elements that require replacements at regular intervals, respectively that imply a different use or the obtaining of the economical advantages is carried out in a different rhythm than that of the fixed group. These characteristics have as a result the use whether of a depreciation rate or of a mean to allocate the depreciable value specific to the component (rate that does not correspond to the one calculated, in general, for the fixed group). Thus, a building and its elevators, a plane and its engines or seats, a blast furnace and its inner walls that require relining at specific periods of time can have different use periods. Also, it is mandatory to determine a real estate in an area separated from its constructions when the estate is purchased. The component identified must have a significant cost in proportion to the total cost of the fixed group and must preserve this patter until the moment it is replaced or is derecognised because it shall be paid separately; in accordance with the provisions of paragraph 43 of the IAS 16 standard "Fixed assets" *"each part of an element of fixed assets with a cost that is significantly in connection with the total cost of the element shall be paid separately*". In practice, the longer the use period of a fixed asset in an enterprise, the more necessary the application of a component-based approach.

1.3.2. Two types of categories identified in accordance IAS 16

The new IAS 16 standard „Fixed assets" present, in paragraphs 13 and 14, two categories of components as follows:

- elements meant to be replaced,
- the expenses generated by regular general inspections to identify faults.

The elements that require regular replacements, given as example above for a building that shall be a headquarter, have mainly periods of use which are lower than for the identified group;

different periods are allowed for the same components, just as the building serves different purposes, with the justifications and the substantiation from the enterprise. The following life time and respectively payments for the identified components are considered for the same building presented above:

- heavy structure and assimilated elements (payment in 50 years);
- outside maintenance works (payable in 25 years);
- central or individual heating, for (payment in 25 years, respectively 15 years);
- electricity (payment in 25 years);
- sanitation equipments, … (payable in 25-30 years);
- elevators (payable in 15 years).

The second category of components that has been identified groups *the expenses generated by the regular general inspections for fault identification* and, according to IAS 16 are recognised in the accounting value of the fixed element if they fulfil the recognition conditions in paragraph 7. In case of a general inspection, its cost is recognised as a replacement, any accounting value remained from the cost of the previous inspection being derecognised.

Such general inspections can be identified when assuring adequate conditions for planes, ships that require revisions of the heavy structures – in the case of ships, of engines – in the case of planes especially to assure they operate in full safety. In case when in a previous inspection its cost has not been identified within the transaction generating the fixed element, we can make estimation of the future inspections in order to consider approximately what has been the cost of the inspection component at the moment of the purchase or of the construction on the fixed asset.

We consider that upon the purchase of a production line in the chemical industry that supplies toxic substances, it has not been taken into account subsequent inspections that shall be carried out in time and that aim to assure good working conditions that do not endanger the life of the personnel. After some cases of illnesses, the management has considered necessary to make inspections, to check the installations. To recognise the production line on component parts, when they are identified, we use the information from the modelling of a value that can be considered as an inspection cost upon the purchase, for derecognising.

1.3.3. The methodology used to identify the component

As I have specified earlier, the component parts of a fixed group are identified if:

- they are subject to replacement at regulate periods; and
- present use periods different from the considered group or, respectively, generate economical benefits in a different rhythm than the group.

Depending on the nature of the activity, respectively its importance within the enterprise, a fixed asset element can be considered a component part only in the structure of a certain enterprise, while for another it is not, being a fixed structure as a group.

We have to follow two phases in the methodology of identification of the component:

- *the technical phase*, that requires previous studies made by the technical departments of the enterprise, with the possibility to establish the division of the fixed structure on component parts, but also the frequent replacement of those component parts;
- the second *accounting*, when the proposal of the technicians are confronted with the information offered by the accounting department, keeping that delimitation that recognises only the component parts whose cost is significant, respecting the provisions of the paragraph 46 that considers that *"if an entity pays separately certain parts of an element of fixed assets, it pays also separately what remains of that element. What remains consists in parts of the element that are not significant if taken individually."*

1.3.4. Practical means of appliance of the recognition based on component parts

The recognition based on component-parts involves two possible:

- *delimitation by division of the fixed structure on first*; and
- *decomposition of the fixed group in component parts only at the entry cost level*.

Delimitation by division of the fixed structure on first recognition involves analyses made by the enterprise, since the date that structure is recorded in the patrimony, and according to these analyses it is indicated or not to decompose the asset in component parts.

This procedure is not limited when applied only in the case of goods purchased new we can specify here the frequent case of constructions that suits very well this approach. The elements that, according to the approach presented above fulfil the recognition conditions as the component parts of a fixed structure on its first recognition, respectively the date when these provisions are first applied, but have not been delimited as such, it is mandatory to be registered as expenses when they are replaced by derecognising. We specify that the IAS 16 standard, as modified, included such a provision in paragraph 13 *"the accounting value of those replaced parts is derecognised in accordance with the derecognising provisions herein."*

The decomposition of the fixed group in component parts only at the entry cost level involves the accounting of the component parts only within the initial cost, as a consequence of the division of the initial structure in several different structures does not change the global cost of the initial fixed asset. But, the replacement of a component part for a superior value than the original one, modifies the gross value of the fixed group.

We consider the following example: if we have a new building purchased at the beginning of 2005 for 500.000 m.u. The lifetime calculated for the building is of 40 years, but it is necessary to renew the installations of central heating – component X, at the end of the first 20 years of use. The estimation of the component X upon the date of the purchase is done by a technical commission for 100.000.m.u.

For the period of time 2005 – 2024 the annual payment of the building is determined as follows:

- heavy structure depreciation (400.000/40years) 10.000 m.u.,
- depreciation for component X (100.000/20years) 5.000 m.u.,
- annual depreciation for the building 15.000 m.u.

In 2024 component X completely paid for is replaced. The cost of the new component is of de 150.000 m.u., the use period is also of 20 years. For 2024-2043 the annual payment is of 17.500 m.u. For the same fixed structure the measurement of the expense with the depreciation of the component parts can differ only as a consequence of different life time for the structure, but also as a consequence of using different depreciation methods than for the base structure.

The delimitation and the recognition of the assets individually (as individual structures, respectively on component parts) or by groups – CGU imply professional reason, each enterprise using therein its experience in order to avoid their misplacement with might affect their future reclaiming.

Instead of conclusion:

Individual and group recognition of fixed assets, according to international standards, requires professional reason and experience from the enterprise management in order to avoid the misplacement of an individual asset component for a cash generating unit when from continuous use it could generate cash inflows individual from those from the use of other assets. The misplacement would distort the information regarding the future reclaiming of the value of the individual asset, respectively the accounting value of the cash generating unit would contain values that should not be attached.

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