REVERSIBLE IMPAIRMENTS AND THEIR IMPACT ON THE ECONOMIC ENTITY’S PERFORMANCE

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Summary: Value adjustment is an instrument designed to cover the present and future risks of economic entities. Adjustments derive from the application of the general principles of accountancy to the accountancy of economic entities. This article is a presentation of reversible impairments, their identification in accountancy including their influence on the performance of the economic entity, under the provisions of the law. Tax-payers are trying to move into a favourable position regarding the tax burdens they are subjected to so as to get maximum benefit from the advantages offered by the tax regulations in force, thus we shall include the influence of the reversible impairments under the tax burden imposed by the Romanian government. The main method of research used here is case study, for a better knowledge of the present stage of the theoretical level and the methodological aspects necessary for the identification of the reversible impairments of entities. The connections between taxability and accountancy, the factors generating reversible impairments, and their components are also being presented. The article ends with the authors’ conclusions on the identification, determination and synthetic presentation of the reversible impairments of an entity.

Key words: reversible impairments, performance, harmonization in accountancy, taxability

JEL Classification: M41, O12, P17

1. Introduction

In applying the general principles of accountancy as provided by the accounting regulations in conformity with the European Directives, the Romanian economic entities are to make an assessment of their assets, to identify the effects of transactions and of other developments as part of the period when they occur. In the management strategies of economic entities, under the conditions of the market economy, in their self-protection against the numerous risks which are likely to appear, the latter deplore the reversible impairment of assets resulting in the formation of impairments. At present the harmonization of the Romanian accounting system is under way, therefore the process is based on the understanding of the accounting regulations in Romania in order to conform to the Accountancy Directives of the European Union as well as to the IAS/IFRS-Standards. Thus, this will also be an attempt at the presentation of the solution adopted by the legal authority regarding the impairment of assets.

The difficult economic conditions should always put up for discussion the value of the corporative assets included in the balance-sheet. When things go wrong, managers dimensionalize operations and try to find ways to reduce costs including costs related to the value of accounting assets. Corporations, auditors as well as analysts expect a series of changes in structure and impairments of assets to be made in the near future (Soroosh and Ciesielski 2002).

With every balance-sheet companies have to determine if there is any indication of asset impairment. Assets are impaired when their value in accountancy exceeds its recoverable value.

2. Research methods

In applying the general principles of accountancy as provided by the accounting regulations in conformity with the European Directives, the Romanian economic entities are to make an assessment of their assets, to identify the effects of transactions and of other developments as part of the period when they occur (Pântea and Bodea, 2011). Consequently, according to the application with no exception of the principles of prudence, of the independence of accounting periods and of continuation of the activity, an economic entity has to execute temporary corrections and adjustments when a reversible impairment or decrease of value of assets has been found: non-current assets, stocks, receivables and treasury liquidities.

Adjustments of value are instruments which allow entities to cover present and future risks. They are formed during the current accounting period by allotting expenses for self-protection. Thus, they may be considered reserves created from expenses and designed for potential risks caused by the impairment of assets or by the occurrence of future facts which might diminish the entity’s assets. Adjustements regarding impairments or decrease of value occurs when the accounting value of one asset exceeds the recoverable value in the case of tangible assets, and the net realization value, in the case of inventories or the just value or the depreciable cost, in the case of financial instruments.

The adjustments for the impairment of non-current assets are the equivalent value of impairments with a reversible character. As a rule these are formed at the end of the year, when stocktaking has shown a reversible
improvement of non-redeemable non-current assets: lands and financial assets. The value of these adjustments will be determined from the registration value (higher) and the real value (lower) determined at stock-taking. For redeemable non-current assets, adjustments will be calculated only if stocktaking has shown deficiencies between the net accounting value (higher) and the stock-list value (lower).

The adjustments for the impairment of inventories are formed and represent corrections generated by the decrease of their market-value. The adjustments are formed from the difference between the real value (lower) of the inventories determined at stocktaking and their accounting value (higher).

The adjustments for the impairment of receivables is determined when reversible impairments have occurred, in which event the registration (accounting) value of the receivables will be compared with their present value, for the differences determined adjustments for impairment will be calculated or the existing adjustments will be updated. There may arise the risk that the entity is not able to totally or partially collect receivables due to the insolvency, bankruptcy, disappearance of clients or debtors.

Adjustments for the decrease of treasury account value are formed when stocktaking has shown that the market-value of short-term investments is below their purchase value. For this disadvantageous difference considered to be a reversible decrease of value, adjustment will be formed from financial costs. In the event that short-term investments are sold or their value increases up to their purchase value, the adjustments are annulled by the corresponding increase of the financial income (Jianu, 2007).

3. Recognition of adjustments – the consequence of the application of the principle of prudence

For non-current assets determination of the recoverable value at the date of balance will be made only if there is an indication of impairment of the same asset and at each date of balance, which is the case in our country, since the stocktaking of assets is made at the same time. The evaluation of non-current assets at their recoverable value aims at reflecting the decision of investment. An entity will take the most advantageous decision in the sense that they will sell the asset if the net selling price exceeds the use value or they will use the asset if they will obtain more benefit by using it. In determining the recoverable value the replacement cost is not taken into account since this reflects the cost of an asset and not the future economic benefits which are recoverable by use or by transfer. Both the selling price and the use value take into account the value in time of the money and the risks that the value and the moment of real treasury flows generated by the asset may be different from those estimated.

According to IASB the use value will be determined by taking into account all the expectations regarding the possible future treasury flows, namely the most probable. The value of the future treasury flows is affected by the risk (variability) associated with the treasury flows. The discount rate must reflect the current market evaluations in time of the money, as well as the risks specific for that asset. This rate represents the current profitability of the investors if they were to choose an investment that might generate treasury flows similar from the point of view of the value, the moment and the risk the entity expects to obtain from that asset. The entity may make their own estimations of the treasury flows, but in this situation the discount rate must reflect, as far as possible, the evaluation of the market regarding the value in time of the money.

Adjustments for the impairment or decrease of value are formed and increased by raising the costs, and annulled or decreased by income from adjustment. If the depreciation in value registered as adjustments decrease during the following periods, a corresponding adjustment will be made (partial annulment of adjustments previously registered in accountancy).

IAS 36 „Impairment of assets” states that the reversal of loss impairment is not a revaluation and complies with the accounting system based on historical costs as long as the reversal does not result in accounting values exceeding the initial cost minus depreciation in the absence of recognition of loss impairment. Reversal of loss impairment must be stated in the Profit and loss statement and any value exceeding the impaired historical cost must be accounted as revaluation.

Reversal to income of loss impairment up to the limit of the depreciated historical cost has aroused much controversy regarding this technique, the main reasons being presented in IAS 38 „Impairment of assets”, according to which the same is to be transposed as follows: (IAS 36)

- reversal of impairment losses are in contradiction with the accounting system based on historical costs when the accounting value is reduced, the recoverable value becomes the new basis of asset costs, thus the reversal of impairment losses should be prohibited or directly recognized in equity as revaluation.
- reversal of impairment losses results in volatility of the reported profits, while the periodical assessments of short-term earnings are not necessarily affected by the changes not realized in the assessment of a long-life asset
- the result of reversal of impairment losses may not be of use in financial statements as long as the write-back value is limited to a value which does not increase the accounting value of the asset beyond its impaired historical cost; thus neither the value written back nor the revised accounting value offer information contents
- in many situations the reversal of impairment losses may result in the implicit recognition of the goodwill generated within the entity
4. Tax implications of the adjustments regarding reversible impairment

“Taxes are a form of rendering one share of the physical and legal entities’ income at the disposal of the state, as obligatory, non-redeemable and without straight and immediate return service, meant to cover the costs of completing its tasks and obligations” (Banc, 2001).

From the above definition we can say that revenues can be considered taxes if they comply with all the following conditions:

1) they make reference to a transfer of money from one particular form of property to the state property;
2) the transfer is obligatory, i.e. provided by the law;
3) the transfer is final and dies involve any straight and immediate obligations undertaken by the state;
4) the money rendered at the disposal of the state is used to complete its tasks and obligations, i.e. for public objectives and activities.

Starting from the limits of the accounting principles/conventions, information-makers appeal to various ways of “forming” up to “de-forming” assets, of the accounting result and implicitly of the income tax. The practices used in this respect are formally named “accounting policies”, “policies of result adjustment” or “result levelling policies” (Ristea, 2001).

Apart from the tax deductibility explicitly provided by the laws in force, there is a series of tax deductions which are not in concrete terms, without expressly being prohibited by law. In practice the existence of such “hidden” (“apparent” tax deductions has been shown, similar to forms of tax evasion “tolerated” and favoured by the uncertain border between legal and illegal. The system of tax deductions is a permanent challenge for the tax-payer who practically oppose the law being situated at the fragile border between legal and illegal. The “hidden” tax deductions aim at offering tax privileges to the tax-payer, sometimes even to the disadvantage of economic performance.

Including impairments into the above, reveals several aspects:

1) forming reversible impairments which are tax-deductible, or impairments which are reversed to non-taxable income, results in the delay of payment of the income tax for the said period
2) forming impairments which are not tax-deductible results in the delay of performance

Starting from these premises, the tax-paying entity is able to speculate on performance and taxation. Thus, if a lower income tax is aimed at, the reversible impairments formed must be tax-deductible. Thus the tax-payer obtains the delay of tax-payment until the reversal to income of the impairment has been realized, which income is taxable within the financial period when this reversal is made. If a lower level of the accounting result is aimed at, the impairments formed may be either deductible or non-deductible, also taking into account that when forming non-deductible impairments the result decreases by both the impairment formed and the income tax on expenses which are non-deductible.

In most cases the entity forms reversible impairments which will lead to a decrease of the payable income tax thus the entity maintains a source of financing obtained without additional costs like, for example, interest in the case of bank loans. Forming such impairments is in close connection with the decision-making system of the entity, a system which allows the managers to analyze the level of the targets of income to be reached for a certain period and to decide, if the intended result has been reached, on forming, under the law, reversible impairments of goods, which may be either tax-deductible or non-deductible. They also have to take into account the fact that if such impairments or not tax-deductible when formed, they will be non-taxable when reversed to income, in conformity with the principle of avoidance of double taxation.

In future economic operations, when reversal to income of impairments is made, an increase of the result is obtained – increase which will be an advantage for the entity’s management aiming at higher targets from one year to another. On reversal to income of impairments which were tax-deductible when formed, there will be an increase of the income tax by the value thereof, whereas the value of the same impairment is evaluated in a currency impaired by the country’s inflation. The impairment of assets operates with very many variables. The change of one or more variables is sufficient for the constant loss to be different. As different losses have different impact on the result and on the net
value of assets, entities are highly creative in choosing the time and conditions for making impairment tests (Feleagă, 2002).

Regarding the reversible impairments from the state’s point of view, we have to indicate that there must be a dynamic approach of the role of the income tax depending on the level of economic progress, efficiency and competitiveness of the local private capital. The Romanian economy entering permanent competition with the other national economies and the interference of the stat tends to decrease, the strengthening of the local private capital will ultimately depend on the fate of the Romanian economy. The income tax should not only be used as an economic and financial instrument to create public income, even if this is important to be considered.

The mechanism of stating, collecting and transferring income tax must be improved during the stage of progress of the national economy, mainly from the perspective of increasing its role as economic and financial instrument, which alongside with other such mechanism should stimulate investments and solid economic relations. Thus, the state is directly influenced by the formation by entities of reversible impairments. In forming tax-deductible impairment, the state at first is not at advantage as the income tax does not reach the state treasury during that financial period. Nevertheless, by maintaining these amounts at the disposal of entities, self-financing is realized which stimulates the entity’s future activity, which activity if profitable and progressing may bring more taxes and duties to the state budget. When reversing initially tax-deductible impairments to income, the income becomes deductible and thus eventually reaches the state budget. When non-deductible reversible impairments are formed, the state is at advantage, since the income tax is calculated and paid on the same since they are formed, whereas by reversal to income they will not be taxed taking into account that the state has already collected the tax on the respective impairment.

5. Results and discussions regarding the impact of reversible impairments on the entity’s performance.

Performance is: “the achievement of corporate targets irrespective of their nature and variety”. Corporate performance shows the capacity of the individual to progress owing to the efforts made. Performance does not stand by itself, it is always the product of comparison. Performance depends on the strategic targets; there is no absolute performance, independent from its targets; evaluation of performance depends on determining the targets by a given situation; performance in a certain situation determined according to certain targets may not be considered performance in a different situation determined by different targets (Lavalette and Nicuescu 2001).

The following is a presentation of a hypothetical situation of formation and annulment of an entity’s adjustments of value. Based on this situation we shall analyze the impact on economic performance (Paraschivescu et al 2007)

At the end of the year N, an economic entity presents the following information:

1. Impairments of non-current assets:
   - intangible assets 2,000 Ron;
   - tangible assets 6,000 Ron;
   - tangible assets in progress 1,000 Ron
2. Impairment of finished products 1,000 Ron and of goods purchased for resale 2,000 Ron;
3. bankruptcy of a customer on debt for 4,500 Ron;
4. impossibility to recover the financial support granted to an associated entity due to insolvability, 2,000 Ron;
5. impairment of short-term investments:
   - shares held by associate entities 500 Ron;
   - redeemed debentures 300 Ron;
   - third-party debenture 150 Ron.
6. The market value of the third-party shares is 2,100 Ron as to the purchase value of 2,500 Ron

In the year N+1 the situation is as follows:

1. Non-current assets:
   - impairment of intangible assets annulled;
   - the land whose impairment was determined in N is sold for 15,000 Ron, the accounting value being 14,000 Ron;
   - impairment of tangible assets in progress did not occur.
2. Impairment of finished products reduced to 3000 Ron, of goods purchased for resale to 1,500 Ron;
3. in N+1 the entire debt of the customer of 4,500 Ron is collected;
4. the financial support granted to an associated entity is recovered to 100%
5. impairment of short-term investments:
   - shares held by associate entities – price recovered, thus the formed impairment of 500 Ron is reversed to income;
   - for redeemed debentures of 300 Ron not occurred and annulled;
   - for third-party debentures 0, impairment of 150 Ron reversed to income.
6. Third-party shares are sold for 2,550 Ron, reversal to income of 400 Ron

The situation of the Profit and loss statement before registration of reversible impairments, taking that the present ratio are identical from one period to the other:
**Chart no. 1** Profit and loss statement before registration of adjustments, Lei

<table>
<thead>
<tr>
<th>Name</th>
<th>Period</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N</td>
<td>N+1</td>
<td></td>
</tr>
<tr>
<td>1. Operating revenues</td>
<td>2,500,000</td>
<td>2,500,000</td>
<td></td>
</tr>
<tr>
<td>2. Operating expenses</td>
<td>1,200,000</td>
<td>1,200,000</td>
<td></td>
</tr>
<tr>
<td><strong>A. Operating result (I-2)</strong></td>
<td>1,300,000</td>
<td>1,300,000</td>
<td></td>
</tr>
<tr>
<td>3. Financial revenues</td>
<td>120,000</td>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td>4. Financial expenses</td>
<td>100,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td><strong>B. Financial result (3-4)</strong></td>
<td>20,000</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>5. Total income (1+3)</td>
<td>2,620,000</td>
<td>2,620,000</td>
<td></td>
</tr>
<tr>
<td>6. Total expenses (2+4)</td>
<td>1,300,000</td>
<td>1,300,000</td>
<td></td>
</tr>
<tr>
<td><strong>C. Current result (A+B)</strong></td>
<td>1,320,000</td>
<td>1,320,000</td>
<td></td>
</tr>
<tr>
<td><strong>D. Gross result (5-6)</strong></td>
<td>1,300,000</td>
<td>1,300,000</td>
<td></td>
</tr>
<tr>
<td><strong>E. Income tax</strong></td>
<td>211,200</td>
<td>211,200</td>
<td></td>
</tr>
</tbody>
</table>

Source: Profit and loss statement of entity

Profit and loss statement of the two years after registration in accountancy of impairments:

**Chart no. 2** Profit and loss account after registration of adjustments, Lei

<table>
<thead>
<tr>
<th>Name</th>
<th>Period</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N</td>
<td>N+1</td>
<td></td>
</tr>
<tr>
<td>1. Operating income Ve</td>
<td>2,500,000</td>
<td>2,500,000</td>
<td></td>
</tr>
<tr>
<td>2. Operating expenses Ce</td>
<td>1,200,000</td>
<td>1,200,000</td>
<td></td>
</tr>
<tr>
<td>3. Income regarding the value of operating adjustments</td>
<td>0</td>
<td>22,500</td>
<td></td>
</tr>
<tr>
<td>4. Expenses regarding the value of operating adjustments</td>
<td>22,500</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td><strong>A. Operating result (1+3-2-4) Rbe</strong></td>
<td>1,277,500</td>
<td>1,322,500</td>
<td></td>
</tr>
<tr>
<td>5. Financial income</td>
<td>120,000</td>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td>6. Financial expenses</td>
<td>100,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>7. Income regarding financial adjustments</td>
<td>0</td>
<td>1,350</td>
<td></td>
</tr>
<tr>
<td>8. Expenses regarding financial expenses</td>
<td>1,350</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td><strong>B. Financial result (5+7-6-8)</strong></td>
<td>18,650</td>
<td>21,350</td>
<td></td>
</tr>
<tr>
<td><strong>C. Current result (A+B) Rert</strong></td>
<td>1,296,150</td>
<td>1,343,850</td>
<td></td>
</tr>
<tr>
<td><strong>D. Gross result (9-10)</strong></td>
<td>1,296,150</td>
<td>1,343,850</td>
<td></td>
</tr>
<tr>
<td><strong>E. Taxable result</strong></td>
<td>1,315,500</td>
<td>1,324,500</td>
<td></td>
</tr>
<tr>
<td><strong>F. Income tax</strong></td>
<td>210,480</td>
<td>211,920</td>
<td></td>
</tr>
<tr>
<td><strong>G. Net result of the period</strong></td>
<td>1,085,670</td>
<td>1,131,930</td>
<td></td>
</tr>
</tbody>
</table>

Source: calculated data

From the data presented in Chart 2 we notice that the entity has recorded positive financial results during the two years of the analyzed period. All the categories of result have increased owing to the reversal to income of the adjustments remaining without object.

We may notice that in the year N, the year of registration of impairment, the accounting result has a negative influence, decreasing by the value of the adjustments created, whereas the taxable result has a positive influence by only 4,500 Ron, the amount of forming adjustments to the customer debts, the expense being tax-deductible.

This, compared to the same period when no impairments were recorded, the gross result decreased by 23,850 while the tax result decreased by only 4,500 Ron, and the income tax by 720 Ron. We may realize the fact that by forming deductible impairments the entity succeeded in a delay of tax payment of 720 Ron regarding the period of forming the adjustment namely period N until the annulment of the adjustment, namely period N+1.

Between the two periods of reference N and N+1 we notice with the gross result double the amount of 23,850 Ron of the reversible impairments recorded in N on expense and then entered to income in period N. With the taxable result the difference is double the amount of 4,500 Ron being the amount of forming adjustment of receivables related to customers, which is tax-deductible.

An analysis of the influence of reversible impairment on performance may be realized based on margin rates (Burja, 2009), as shown in the chart below:

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55
Chart no. 3 Performance expresses in margin rates, %

<table>
<thead>
<tr>
<th>Rates</th>
<th>Formula</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate of profitability of resources</td>
<td>( \frac{R_{be}}{Ct} \times 100 )</td>
<td>Before adjustment</td>
</tr>
<tr>
<td>Rate of profitability of current resources</td>
<td>( \frac{R_{crt}}{Ccrt} \times 100 )</td>
<td>N</td>
</tr>
<tr>
<td>Rate of profitability of total income</td>
<td>( \frac{R_{be}}{Vt} \times 100 )</td>
<td>N</td>
</tr>
<tr>
<td>Rate of profitability of operating resources</td>
<td>( \frac{R_{e}}{Ce} \times 100 )</td>
<td>N</td>
</tr>
<tr>
<td>Rate of profitability of current income</td>
<td>( \frac{R_{crt}}{Vcrt} \times 100 )</td>
<td>N</td>
</tr>
<tr>
<td>Rate of profitability of operating income</td>
<td>( \frac{R_{e}}{Ve} \times 100 )</td>
<td>N</td>
</tr>
</tbody>
</table>

Source: calculated data

The diagram below presents the evolution of the rates of profitability for the 3 analyzed periods: before adjustment, N-the period of forming the adjustment and N+1 the period of annulment of the adjustment.

Diagram no. 1 Evolution of rates of profitability

With these rates of performance measurement we may notice the fact that from the year of reference before registration of impairment for the year N, the same decrease owing to the adjustments on the operating result, which result is taken into account when calculating the rates.

The value of the rates increases from the year N to the year N+1 owing to reversal to income of income impairment which have no object in the year N+1. Versus the year of reference before registration of adjustments an increase of the rates of profitability may be noticed, however at a lower value due to the fact that adjustments for the impairment of assets had not been formed.

6. Conclusions and proposals

Taking into account all the aspects mentioned above regarding reversible impairments and their treatment in Romanian accountancy, their importance in the management of financial resources and in achieving performance by any entity, we plead for the concentration on information referring to the benefit or the impediment the adjustments provide to the corporate image.

Thus, as a benefit, in the case of tax-deductible reversible impairment, when profit is made the same sustains the entity’s financial situation by retaining at its disposal of a source of financing by not paying the accrued income tax. On annulling the impairment, income tax will be paid, however in devaluated currency.

When the entity registers impairment of assets, which are not tax-deductible, the gross result decreases, but with no influence on the income tax, however with a negative influence on the indicators of performance when they are formed and a positive influence when they are annulled. Taking all this into consideration, we consider that the most
important issue in the management of adjustments is the determination of the right value of the adjusted goods, in the sense that this value must be closest to the real value at the time of drawing and submitting the financial statement.

As a consequence of these findings, we recommend:

- maximum attention in forming adjustments which are not tax-deductible as in the short run the same have a negative influence on the entity’s performance, which might have an unfavourable influence on the decisions made by possible investors, by the banks – in the event loans are made. Also, the fact that reversal to income of reversible impairments increases the gross result and implicitly the rates of performance calculated on this basis;
- registration of adjustments which are tax-deductible, which adjustments sustain the finding of financing sources by the State until the reversible impairments have been reversed to income. Such source may be important since there is no accrued interest, while due to the inflation on the Romanian market, payment will be in a devaluated money.

A good manager will consider well when forming adjustments regarding reversible impairments, first under the provisions of the law, at the same time taking into account the entity’s future aims, for a balance between the provisions of the law and the targets envisaged for the entity’s management.

Bibliography