THE FINANCIAL REPORTING FOR COUNTY GOVERNMENTS AND OTHER PUBLIC SECTOR ENTITIES CONFERENCE

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Pride Inn Beach Resort and Spa – Mombasa

Assets and liabilities policy and its implication on Accrual Accounting

- Background
- Assets and Liabilities Policy
- Property Plant and Equipment (IPSAS 17)
- Policy implications

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Background

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Asset Management Dilemma

- The Government has for years owned assets and incurred liabilities but there has been no standardized policy or system to record the existence of assets immediately they are procured and liabilities when they are incurred.
  - No adequate guidelines have been documented to provide guidance on planning, acquisition, operation and maintenance, disposal as well as recording and reporting on assets.
  - No adequate guidelines on the identification, securing tenure, recording and reporting on liabilities.
  - Different approaches adopted to assets and liabilities based on whether entities are using accrual or cash basis of accounting.

Asset Management Dilemma

- ❑ Asset and liabilities management not aligned to, and integrated with, entities strategic, corporate and financial planning, in the public sector.

- ❑ No adequate measures to define assets and liabilities
  - what is it?
  - who owns it?
  - who has it?
  - where is it?
  - how did we get it?
  - what does it do?
  - how big/much is it?
  - what is the value?
  - who wants it?
  - who knows about it?

Assets and Liabilities Policy

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Asset and Liability Management Guidelines

- Issued pursuant to section 139(3) of the Public Finance Management (National Government) Regulations (2015) that require the National Treasury to provide Guidelines on Assets Management – July 2020

  - to address the asset and liability management dilemma for public sector entities

  - provide direction on assets and liabilities management irrespective of the basis of accounting adopted

Aims of the Guidelines

- Promoting accountability on assets and liabilities management;
- Effective management and safeguard of public assets;
- the standardization in all public sector entities of:
  - identification, acquisition, maintenance, disposal of, valuation/revaluation, recording and disclosure of assets in the public sector.
  - identification and disclosure of liabilities in the public sector.
  - assets and liabilities data management reporting.
- Proper authorisation of acquisition and disposal of assets; and
- Accurate and timely information and reporting to facilitate decision making
- Consolidation and maintaining an updated inventories of assets and liabilities for both national and county levels of government.

Compliance and Disclosure of assets and liabilities in financial statements

- National Treasury, among other responsibilities will monitor assets and liabilities management systems in the public sector and generate reports and give recommendations to accounting officers.
- Accounting officers shall ensure compliance with the Guidelines
- Disclosure/ reporting requirements of assets and liabilities in the financial statements of public sector entities shall be guided by the reporting templates prescribed by PSASB.
- The guidelines applies to entities using IPSAS Cash, IPSAS Accrual and IFRS.

Asset and Liabilities Identification

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Definition

- The conceptual framework for IPSAS defines an **asset** as a resource owned, or in some cases, controlled, by an individual or organisation as a result of past events and from which future economic benefits or social benefits are expected to flow to the entity.

- Assets may be movable or immovable, tangible or intangible, and include equipment, land, buildings, animals, inventory, cash and cash equivalents, receivables, investments, natural resources like wildlife and, intellectual rights vested in the state or proprietary rights.

Classification

- The Guidelines have broadly classified assets as either non-financial or financial:
  - non-financial assets, which comprise physical and intangible assets; and
  - financial assets which comprise all other assets.

- Accounting for non-financial assets are detailed in relevant IPSAS and IFRS for each category of assets in addition to other requirements that could be prescribed by the Cabinet Secretary, PSASB and other mandated body.

- Public entities are guided to apply accounting standards as currently approved by the PSASB

Non – Financial Assets

- Non - financial asset is an item that has its value determined by physical and tangible characteristic for example stores, equipment, land, buildings, animals, inventory, stock, natural resources like wildlife, intellectual rights vested in the state or proprietary rights. Non-financial assets include:

  - tangible/ fixed assets such as land, buildings, infrastructure, plant and equipment, transport assets, biological assets and, heritage and cultural assets;
  - intangible assets including IT software systems and intellectual property; and
  - inventories and other stocks held by public sector entities.

Financial Assets

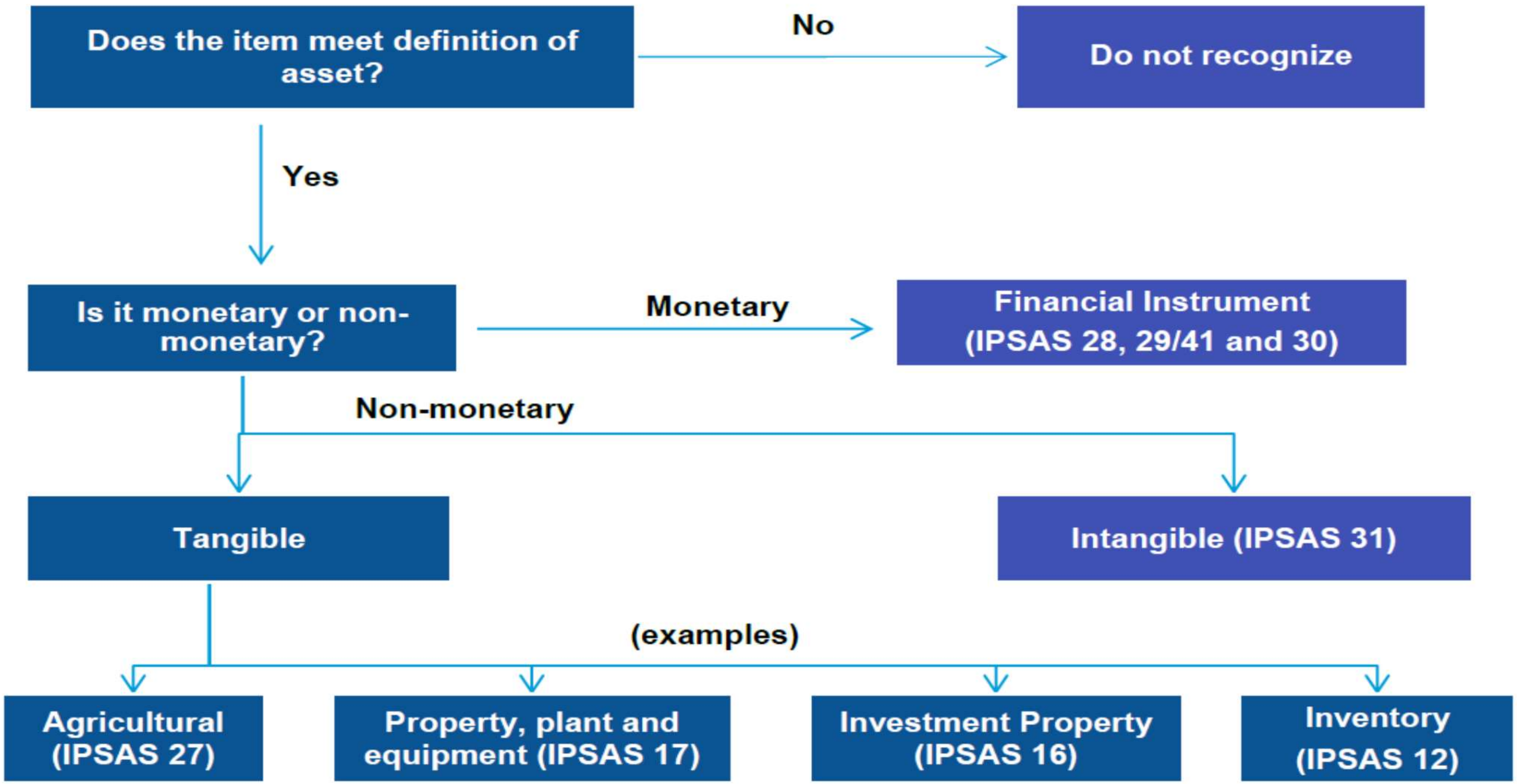
- Financial assets refer to assets that arise from contractual agreements on future cash flows or from owning equity instruments of another entity. Examples of financial asset are:
  - Cash and bank
  - Equity instruments of other entities held by the entity (for example, shares).
  - A contractual right to receive cash or another financial asset from another entity (i.e. receivables).
  - A contractual right to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity (for example derivatives)

Assets and liabilities in financial statements

Categories of assets and liabilities in the guidelines

	Non- financial assets	Financial assets	Liabilities
1	Land	Investments	Loans payable/ borrowings
2	Building and building improvements	Loans receivable	Long term employee benefits
3	Investment property	Accounts receivable	Accounts payable
4	Intangible assets	Other receivables	Accruals
5	Heritage assets	Cash and cash equivalents	Provisions
6	Inventories	Contingent assets	Contingent liabilities
7	Road infrastructure		Other liabilities
8	Railway infrastructure		
9	Other infrastructure		
10	Motor vehicles and other transport assets		
11	Computers and other ICT equipment		
12	Furniture, fittings and equipment		
13	Plant & Machinery		
14	Biological assets		
15	Subsoil assets		

IPSAS application



Property Plant and Equipment – IPSAS 17

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Introduction

PP&E are tangible items that:

- Are held for use in the production or supply of good or services for rental to others, or for administrative purposes; and

- Are expected to be used during more than one reporting period.

Scope of PPE

The PSASB Kenya has adopted the following standards guiding the accounting for assets:

Asset class	IPSAS	IFRS/ IAS
Non-financial assets		
Property, Plant and equipment Land Buildings and building improvements Heritage assets Road infrastructure assets Railway infrastructure assets Other infrastructure Motor vehicles and other transport assets Computers and other ICT equipment Furniture, fittings and equipment Plant and Machinery	17	IAS 16

Scope of PPE

Infrastructure Assets

- While there is no universally accepted definition of infrastructure assets, these assets usually display some or all of the following characteristics:

  – They are part of a system or network;

  – They are specialized in nature and do not have alternative uses;

  – They are immovable; and

  – They may be subject to constraints on disposal.

Scope of PPE

Infrastructure Assets

- Infrastructure assets meet the definition of property, plant, and equipment and should be accounted for in accordance with IPSAS 17.

- Examples of infrastructure assets include road networks, sewer systems, water and power supply systems, and communication networks.

Scope of PPE

Heritage Assets

- Heritage assets have cultural, environmental, or historical significance that is worth preserving perpetually.

- Examples of heritage assets include historical buildings and monuments, archaeological sites, conservation areas and nature reserves, and works of art.

Scope of PPE

What about Spare Parts, Servicing Equipment, Major Parts, Standby equipment?

- ❑ Spare parts and servicing equipment are usually carried as inventory and recognized in surplus or deficit as consumed.

- ❑ However, major spare parts and stand-by equipment qualify as property, plant, and equipment when an entity expects to use them during more than one period.

- ❑ Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant, and equipment, they are accounted for as property, plant, and equipment.

Recognition

- The cost of an item of property, plant, and equipment shall be recognized as an asset if, and only if:

- It is probable that future service potential or economic benefits associated with the item will flow to the entity; and

- The cost or fair value of the item can be measured reliably.

Recognition

- IPSAS 17 does not require, but does not preclude, the recognition of heritage assets that meet the definition of PP&E.

- It is often difficult to make a reasonable estimate of the future benefits associated with heritage assets since they are rarely held for their ability to generate cash inflows, and there may be legal or social obstacles to using them for such purposes.

- The service potential of heritage assets is limited to their cultural, environmental, or historical significance.

Recognition

- If an entity recognizes heritage assets, it must apply the disclosure requirements of IPSAS 17 and may, but is not required to, apply the measurement requirements of IPSAS 17.

- Some heritage assets have future economic benefits or service potential other than their heritage value, for example, an historic building being used for office accommodation. In these cases, they may be recognized and measured on the same basis as other items of property, plant, and equipment.

Acquisition and Measurement

An item of PPE can be acquired as follows:

1. Purchased (Normal terms such as credit or cash payment or exchanged with another asset – trade in)

2. Constructed (especially for buildings and other major plant and machinery)

3. Received as a donation.

Acquisition and Measurement

Depending on how the asset is acquired, an item of PPE shall be measured:

1. At purchase price plus all other costs incurred to get the asset ready for use such as freight, insurance, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates, assembling, installation and testing.

Acquisition and Measurement

2. At construction costs direct internal employee salaries and benefits, materials and supplies, equipment, temporary site buildings, legal and other professional fees, borrowing costs such as interest on loans as per IPSAS 5.

3. For donated assets = non exchange transactions (fair value)

Subsequent Expenditures/cost

- Subsequent Expenditure should be expensed if the costs will not lead to increased service potential of an asset i.e. an asset will generate future economic benefits.

- Examples of subsequent expenditures are as follows:

- **Repairs and maintenance**
- **Replacement of components**
- **Cost of major inspections**

Subsequent Expenditures/cost

Repairs and maintenance

- Under the recognition principle, the carrying amount of an item of property, plant, and equipment does not include the costs of the day-to-day servicing of the item.
- These expenditures would not meet the recognition criteria as they would not result in service potential or economic benefits flowing to the entity.
- Rather, these costs are recognized in surplus or deficit as incurred.

Subsequent Expenditures/cost

Replacement of components

- Parts of some items of property, plant, and equipment may require replacement at regular intervals.

- For example, a road may need resurfacing every few years and a furnace may require relining after a specified number of hours of use.

- An entity recognizes the costs of replacements in the carrying amount of an item of property, plant, and equipment when incurred if the recognition criteria are met.

Subsequent Expenditures/cost

Cost of major inspections

- A condition of continuing to operate an item of property, plant, and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced.

- When each major inspection is performed, its cost is recognized in the carrying amount of the item of property, plant, and equipment as a replacement if the recognition criteria are satisfied.

- Any remaining carrying amount of the cost of previous inspection (as distinct from physical parts) is derecognized.

Subsequent Expenditures/cost

Example

A government department has spent sh.12 million to install equipment at its water treatment facility to meet new legal water quality regulations. The equipment has had no effect on the quality and volume of the water treated or the expected life of the treatment plant.

Question: Should the expenditure be capitalized as PP&E?

End of period Measurement

At the end of the financial period, an item of PPE should be measured at either:

1. Cost model - property, plant, and equipment is carried at its cost, less any accumulated depreciation and any accumulated impairment losses.

or

2. Revaluation model - property, plant, and equipment is carried at a revalued amount, being its fair value less any subsequent accumulated depreciation, and subsequent accumulated impairment losses.

End of period Measurement

	Cost Model	Revaluation Model
Initial Recognition	Cash price or equivalent or fair value at date of acquisition	
Subsequent	Original cost	Fair value at date of revaluation
Carrying Amount	Original cost less accumulated depreciation and impairment losses since recognition	Revalued amount less accumulated depreciation based on revalued amount and impairment losses subsequent to revaluation date

Cost Model and Depreciation

All PP&E except land is subject to depreciation

- The depreciable amount of an asset is expensed on a systematic basis over its useful life to surplus or deficit for each period unless it is recognized in the carrying amount of another asset
- Depreciation begins when an asset is in operation
- Reviewed at each annual reporting date
- Each significant component is depreciated separately

Revaluation

Pros	Cons
Revaluation provides more relevant information for management and decision making as it reflects the current value of long-lived assets rather than original cost.	Costs of undertaking valuations and tracking changes in value.
Depreciation based on current values of assets better reflects the true cost using assets particularly long-lived assets.	Revaluation accounting is more complex resulting in the need for ongoing of tracking account adjustments.
Provides better information for assessing accountability and decision making.	Results in volatility in reported results as the amount of revalued assets fluctuate overtime.
Carrying long lived assets at revalued amounts improves management leading to adequate reinvestment and renewal.	Revalued amounts may not be the same as asset renewal costs required to sustain service levels.

De-recognition (removal from the financial statements)

- The carrying amount of PP&E is derecognized:
  - On disposal
  - When no future service potential or economic benefits is expected from its use or disposal
- Gain or loss on derecognition is included in surplus or deficit
- Gain/loss = Cash Proceeds if any – Book Value on date of Disposal

Disclosures

- For each class of PPE
  - The measurement bases
  - The depreciation methods
  - The useful lives or the depreciation rates used
  - Gross carrying amount and accumulated depreciations at beginning and end
  - Reconciliation of opening and closing balances
- Specific disclosures for the revaluation model
- Other disclosures e.g. restrictions on title, contractual commitments etc.

Disclosures

The primary disclosures include:

a) The measurement bases used for determining the gross carrying amount (cost model or revaluation model)

b) The depreciation methods used/ useful lives/rates used;

c) The gross carrying amount and the accumulated depreciation (impairment losses) at the beginning and end of the period;

d) A reconciliation of the gross carrying amount and accumulated depreciation at the beginning and end of the period

Disclosures

For revaluation model:

a) The effective date of the revaluation and the independent valuer
b) The methods and significant assumptions applied in estimating the assets' fair values;
c) The extent to which the assets' fair values were determined (reference to observable prices in an active market or recent market transactions on arm's length terms, or were estimated using other valuation techniques);
d) The revaluation surplus, indicating the change for the period; and
e) The sum of all revaluation surpluses/deficits for individual items of property, plant, and equipment within that class.

Transitioning to Accrual PPE

Assuming that previously, the entity was using cash basis, therefore PPE was being expensed as acquired, the following broad approach is required:

1. Identify all assets that fall under PPE as defined by IPSAS 17 and should be recognized (check asset register)

2. If available, use the book value as the deemed cost for first time statement of financial position. If not available, then use fair value of the asset. If not available, use fair value of similar assets. If not available, then use any other valuation techniques.

Policy Implications

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Identification and recording of non- financial assets

- A public sector entity shall identify all non-financial assets under their ownership and those held under finance leases.
- The Accounting Officer shall prepare registers of all non-financial assets using the approved formats.
- Where an asset does not have ownership documents due to various reasons, the Accounting Officer shall gazette the said assets. In the absence of objection from any party, the gazette notice shall serve as the document of ownership document.

Valuation

- Where information on the cost price of assets is available, this should be utilised. Where cost information is not available a value of Kshs 1.00 should be applied for the initial recognition. This will ensure that the asset is captured on the register, which will then represent a complete list of assets on hand, for management purposes.
- National Treasury, in conjunction with other stakeholders, shall provide policy direction on standard values which would then be applied to these older assets listed at Kshs 1. 00.
- Where an entity that has been using cash basis of accounting and has carried out valuations of its assets in the last 3 years, it could adopt those valuations for purposes of maintaining its asset registers.
- Revaluations of assets shall only be carried out with the approval of the National Treasury and shall be conducted by the Government valuer.

Accounting for Non – Financial Assets

- A public sector entity that adopts accrual accounting for the first time in accordance with International Accounting Standards shall initially recognize non-financial assets at cost or fair value. For assets that were acquired at no cost, or for a nominal cost, cost shall be taken to the asset's fair value as at the date of acquisition.

- The public sector entity shall recognise the effect of the initial recognition of non-financial assets as an adjustment to the opening balance of accumulated surpluses or deficits for the period in which accrual accounting is first adopted in accordance with IPSAS or IAS.

- For entities that have already adopted accrual accounting, the Accounting Officer shall review the capitalization thresholds, useful lives/ depreciation rates as well as depreciation methods used and ensure alignment with these guidelines. Any variations shall be treated as changes in accounting estimates in the financial records and, treated in accordance with IAS 8 and IPSAS 3 - Accounting Policies, Changes in Accounting Estimates and Errors.

Financial Assets

- Determination of opening balances of financial assets and liabilities involves a thorough examination of all records available. Each public sector entity needs to:
  - compile an aggregate list of all records for financial assets and liabilities;
  - check that the amounts recorded are correct;
  - check that the items are legally enforceable;
  - Ensure that the recorded amounts are complete to include all financial assets and liabilities;
  - assess the likelihood of recovering receivables – check that contact details for individuals or entities are correct and assess whether the individuals or entity has the ability to pay the amount owed;
  - where a write-off, write-down or waiver of financial assets and liabilities is proposed, the Accounting Officer needs to carry out any procedures required before such action, document the recommended action, record details of any approval obtained and update the financial records.
- The entire process needs to be thoroughly documented to enable opening balances to be established and to provide an audit trail.

And Finally………

Asset management is more complex in the public sector than the private sector …

… public bodies are driven by policy for common good