

accounting for non-current/fixed assets relevant to CAT Paper 3

classification and timing

■ **The Study Guide for CAT Paper 3, *Maintaining Financial Records* contains three study sessions relating to non-current assets. Students often find this to be a difficult area of study, but these difficulties can be overcome by breaking the whole area down into smaller parts. In effect, this is what the Study Guide seeks to do by specifying a number of 'outcomes' in each session. By ensuring that each outcome is clearly understood, students can be confident that they are well prepared to deal with any questions that may be set, and will also be able to apply their knowledge in the workplace.**

This article provides an overview of some of the material relating to *Study Guide* Sessions 5 (Assets), 6 (Non-current assets I) and 7 (Non-current assets II). The term 'non-current asset', used in the *Study Guide* for the International paper, is used throughout, as opposed to the equivalent term ('fixed asset') from the UK *Study Guide*. The international terms 'trade receivables' and 'trade payables' are also used, rather than the UK equivalents 'trade debtors' and 'trade creditors' respectively.

CAPITAL AND REVENUE EXPENDITURE

In accounting, a distinction is made between capital expenditure and revenue expenditure.

Revenue expenditure is expenditure on assets which will be consumed within an organisation's normal operating cycle.

Another way of looking at this is that revenue expenditure is expenditure on assets which are intended for conversion into cash within the normal operating cycle.

Capital expenditure relates to assets which will remain in use over a number of accounting periods – or which are not intended for conversion into cash in the short term.

From this, it can be seen that capital expenditure allows an organisation to operate and thus generate profits. Therefore, another way of describing this difference is that capital expenditure improves the revenue-generating potential of the organisation, but revenue expenditure maintains it.

Perhaps the best way to make sense of this rather theoretical explanation is to consider different types of businesses, and the items on which they incur expenditure. This is important as each classification is reported in a different manner.

Revenue expenditure is reported in the income statement as an expense. Capital expenditure is reported on the statement of financial position (balance sheet) as a non-current asset. A moment's reflection on this will indicate that incorrect classification of expenditure will lead to a misstatement of profit. For example, if revenue expenditure is classified as capital expenditure, expenses will be understated. This will lead to profit being overstated. If we apply this to the accounting equation, we can see that, as a result of

the overstatement of profit, capital will be overstated. Also, assets will be overstated because non-current assets will have been incorrectly increased.

DEPRECIATION

The purpose of depreciation

Depreciation is the term used to describe the process of allocating a share of the costs of non-current assets to each accounting period. It may be useful to think of this as charging against profit the cost of those items which improve the revenue-generating capacity of the business.

If we were to charge the full cost of assets which will be used for five years against the profit of the year in which they are purchased, profit would be distorted. It would be reduced – perhaps even wiped out – when capital expenditure is incurred and increased when no capital expenditure takes place. This would undermine the reliability of accounting information.

Calculation of depreciation

Accounting standards (IFRSs and FRSSs) do not define a single method of calculating depreciation. Rather, the principle to be applied is that the charge against profit over the useful economic life of the asset should reflect the cost of the use of the asset.

There are, therefore, a number of possible methods which can be used. The *Study Guide*

GLOSSARY OF TERMS

Accumulated depreciation

The total amount of depreciation charged on an asset from its acquisition to date.

Acquisition

The term used to describe the purchase of a non-current asset.

Current asset

An asset which is intended for conversion into cash in the short term, the benefit of which is consumed in the normal operating cycle of the business.

Depreciation

The systematic charging of the cost of a non-current asset against the accounting periods during which it is used to generate revenue.

Income statement

A statement of revenue earned and costs incurred for a specified period, representing the financial performance of the business.

Net book value

The amount of the cost of a non-current asset which has yet to be depreciated (ie cost less accumulated depreciation).

Non-current asset

An asset which is not intended for conversion into cash in the short term. Therefore, the benefits are consumed over a number of accounting periods.

Part exchange

Using the sale of a non-current asset as part of the payment for the acquisition of another non-current asset. Also referred to as 'trade-in'.

Statement of financial position (balance sheet)

A statement of assets, liabilities and capital at a particular point in time, representing the financial position of the business at the statement date.

Trade-in

An alternative term for 'part exchange'.

for Paper 3 specifically refers to the straight-line and reducing balance methods. The issue for candidates is how to carry out calculations correctly for both methods.

The very simple difference is that the straight-line method is based on the cost of the non-current asset while the reducing balance is based on the net book value.

The straight line method is usually expressed as a percentage (eg 20% per annum) but it might also be expressed in terms of the useful economic life of the asset. If this approach is taken, then the percentage rate can be found by dividing 100 by the useful economic life (eg a useful economic life of five years is the same as 20% per annum).

Most questions in Paper 3 do not require the depreciation charge to be adjusted for an asset held for less than the full year. This is usually communicated by stating that a full year's depreciation is charged in the year an asset is purchased, and no depreciation is charged in the year of its disposal.

The alternative treatment is that depreciation is only charged for the part of the year for which an asset is held. This is sometimes expressed as 'pro rata'. In such circumstances, the approach is to first calculate the depreciation charge that would have applied if the charge for a full year was required. The annual depreciation is then converted to the required period by dividing by 12 and multiplying by the number of months for which the asset was held.

Examples 1 and 2 on page 61 illustrate these points.

ACCOUNTING ENTRIES

Acquisition

The term 'acquisition' rather than 'purchase' is normally used with regards to non-current assets. The two terms mean exactly the same, but in order to avoid confusion between expenditure on non-current assets (capital expenditure) and expenditure on goods for resale (revenue expenditure), we tend to refer to 'acquisition of a non-current asset' and 'purchase of goods for resale'.

To record the acquisition of a non-current asset we need to remember that, as for any

other transactions, the dual aspect must be reflected. This requires clear thinking – especially if the cost is not paid immediately. Therefore, the best way to consider this is to start with a straightforward acquisition, which is paid in full at the point of acquisition. We can then adapt our treatment to reflect an acquisition on credit or by raising some form of finance. Finally, the most complex possibility – when part of the cost is settled by selling a non-current asset – is considered in the section below on 'part exchange'.

When a non-current asset is paid for immediately, the payment is likely to be by cheque. As non-current assets are usually quite expensive, it is unlikely that any organisation would use cash (notes and coins). Thus, the dual aspect is that non-current assets have increased, while the current asset of the balance at the bank has reduced. (Or, if the bank account is already overdrawn, the overdraft will increase.)

So, the double entry is as follows:

Debit	Non-current assets at cost
	Credit Bank

If the cost of the asset is not paid immediately, two possibilities are that a normal period of trade credit has been obtained, or a loan has been raised to pay for the asset. (It should be noted that the financing of non-current assets through a leasing arrangement is outside the scope of the syllabus for CAT Paper 3.) In the case of trade credit, the credit entry will be to the trade payables account. If a loan is raised, we will create a loan account with a credit entry, and debit the cash account with the receipt of the loan, and then the double entry is the same as above.

Examples 3 to 5 on pages 61 and 62 illustrate these points.

Depreciation

It is important to note that depreciation does not involve a cash transaction. Rather, it is a book entry, whereby a share of the cost of non-current assets is transferred to create a charge against profit. The accounting equation

is maintained, as the value of non-current assets is reduced, by the same amount as the charge against profit.

From this, it follows that the depreciation charge leads to a debit entry in an expense account (depreciation charge). The corresponding credit entry is to the non-current asset. As it is convenient to maintain a record of the cost of non-current assets, we carry the reduction in value to date as a separate balance. Therefore, the credit entry is not made in the same ledger account as the cost of non-current assets. Rather, a separate account (accumulated depreciation) is used to record the amount of depreciation charged to date.

Thus the entry is:

Debit	Depreciation charge
	Credit Accumulated depreciation

Disposal

To deal with the disposal of a non-current asset, several steps are required.

As discussed above in the section on depreciation, the balances relating to the asset are carried in two accounts. So, to remove the asset from the accounting records, we must make a credit entry in the cost account, and a debit entry in the accumulated depreciation account. These entries are completed with corresponding entries in the asset disposal account. The entries are:

Cost of asset:

Debit	Asset disposal account
	Credit Non-current assets at cost

Accumulated depreciation to the point of disposal:

Debit	Accumulated depreciation account
	Credit Asset disposal account

These entries mean that the net book value has been transferred to the disposal account. If we compare the net book value with the proceeds of disposal, the resulting balance is the profit or loss on sale. A profit arises if the proceeds are greater than the net book value; if the proceeds are less than net book value, a loss has been sustained. The balance on the disposal account is transferred to the income statement.

Therefore, we credit the disposal proceeds to the disposal account. If the proceeds have been received immediately, they will have been lodged to the bank, leading to a debit entry in the bank account. If the buyer has been allowed a period of credit, this will be reflected by a debit entry in the trade receivables account. The other possibility is that the disposal of the asset has been a part-exchange transaction. This is considered below.

Examples 6 and 7 on page 62 illustrate these points.

Part exchange

When a non-current asset is replaced by another non-current asset, it is quite common to use the sale of the original asset as part of the transaction. This is referred to as 'part exchange' (or sometimes 'trade-in'). By stating the transaction in this way, we have recognised that it is, in fact, two separate transactions.

The first transaction is the sale of a non-current asset. This is dealt with in broadly the same way as the straightforward sale discussed above. The difference is that instead of receiving payment for the asset sold, the sale proceeds settle part of the cost of the acquisition. So the debit entry is made in the non-current assets at cost account. This means that the amount to be settled is the balance of the cost of the acquisition. This is recorded in the same way as any other acquisition, except that the value of the entries is less than the full cost of the acquisition.

Example 8 on page 62 illustrates this point.

Scrapping

When an asset is scrapped, this simply means that it has been disposed of, but the sale proceeds are nil. Therefore, there is nothing to offset against the net book value, which represents a loss.

Example 9 on page 62 illustrates this point.

This article provides an overview of some of the material relating to Study Guide Sessions 5 (Assets), 6 (Non-current assets I) and 7 (Non-current assets II)

EXAMPLES 1 AND 2: CALCULATION OF DEPRECIATION

At 31 July 20X6, Imogen had non-current assets which had cost \$310,000. At the same date, the accumulated depreciation on the assets was \$120,000. She had not disposed of any non-current assets during the year to 31 July 20X7, but acquired an asset at a cost of \$79,200 on 1 January 20X7. Imogen depreciates her non-current assets at a rate of 25% per annum. What is Imogen's depreciation charge for the year to 31 July 20X7?

EXAMPLE 1: CALCULATION OF DEPRECIATION ASSUMING THAT NO DEPRECIATION IS CHARGED IN THE YEAR OF ACQUISITION

- i **On a straight-line basis**
At the year end the cost of non-current assets is \$389,200 (\$310,000 + \$79,200)
Depreciation for the year is therefore \$389,200 x 25% = \$97,300
- ii **On the reducing balance basis**
At the year end, the net book value of assets is \$269,200 (\$389,200 - \$120,000)
Depreciation for the year is therefore \$269,200 x 25% = \$67,300

EXAMPLE 2: CALCULATION OF DEPRECIATION ASSUMING THAT DEPRECIATION IS CHARGED FOR THE PERIOD ASSETS ARE HELD (PRO RATA)

Note that it is necessary to calculate the depreciation on assets according to the part of the year they have been held; in this case, that is \$310,000 for the full year, and \$79,200 for seven months.

- i **On a straight-line basis**
Depreciation for the year is therefore:
\$310,000 x 25% = \$77,500
plus \$(79,200 x 25%) x 7/12 = \$11,550
= \$89,050
- ii **On the reducing balance basis**
Held for full year: Cost \$310,000
less accumulated depreciation \$120,000
Net book value \$190,000 x 25% = \$47,500
Acquired during year Cost (\$79,200 x 25%) x 7/12
= \$11,550
Total charge \$59,050

EXAMPLES 3, 4 AND 5 – ACQUISITION OF ASSET

Arnold has acquired a non-current asset at a cost of \$65,000. What journal entries should be made to record the acquisition?

EXAMPLE 3

Assuming that he paid for the asset in full by cheque:

Debit	Non-current assets at cost	\$65,000
Credit	Bank	\$65,000

EXAMPLE 4

Assuming that he obtained one-month's credit:

Debit	Non-current assets at cost	\$65,000	
	Credit	Trade payables	\$65,000

EXAMPLE 5

Assuming that he obtained a three-year loan:

Debit	Bank	\$65,000	
	Credit	Loan account	\$65,000

Debit	Non-current assets at cost	\$65,000	
	Credit	Bank	\$65,000

Note that when Arnold's statement of financial position (balance sheet) is prepared, the balance on the loan should be split between current liabilities and non-current liabilities on the basis of the agreed repayment pattern.

EXAMPLES 6 AND 7 – DISPOSAL OF ASSET

During the year to 30 June 20X7, Jimmy sold a non-current asset for \$36,000. He had acquired the asset three years ago at a cost of \$180,000. At the date of disposal of the asset, the accumulated depreciation was \$138,000.

What was the profit or loss on disposal, and what journal entries are needed to record the disposal?

EXAMPLE 6

Assuming that he lodged the sale proceeds to his bank:

Net book value at date of sale:	\$42,000	(\$180,000 - \$138,000)
Proceeds	\$36,000	
Thus loss on disposal	\$6,000	

Cost of asset sold:

Debit	Asset disposal account	\$180,000	
	Credit	Non-current assets at cost	\$180,000

Accumulated depreciation on asset sold:

Debit	Accumulated depreciation	\$138,000	
	Credit	Asset disposal account	\$138,000

Disposal proceeds:

Debit	Bank	\$36,000	
	Credit	Asset disposal account	\$36,000

Note that at this point the asset disposal account will have a debit balance of \$6,000. This is written off to the income statement as a charge against profit.

EXAMPLE 7

Assuming that he allows a period of trade credit to the buyer:

In this case, everything is as in **Example 2**, except for the journal entry for the proceeds. This will now be:

Debit	Trade receivables	\$36,000	
	Credit	Asset disposal account	\$36,000

EXAMPLE 8 – PART EXCHANGE

During the year to 31 May 20X7, Carlos acquired a new non-current asset at a cost of \$155,000. This was a part exchange transaction with the seller allowing Carlos a part exchange allowance of \$21,000. Carlos settled the remaining balance on one-month's credit. The asset traded in had been bought at a cost of \$120,000. At the time of the disposal, the accumulated depreciation was \$103,000.

What is the profit or loss on disposal, and what journal entries are required to record the transaction?

The profit or loss on disposal is the difference between the net book value at the date of disposal and the sale proceeds (the part exchange allowance).

This is:	Net book value	\$17,000	(\$120,000 - \$103,000)
	Proceeds	\$21,000	
	Thus	Profit	\$4,000

Journal entries:

Cost of asset part exchanged:

Debit	Asset disposal account	\$120,000	
	Credit	Non-current assets at cost	\$120,000

Accumulated depreciation on asset part exchanged:

Debit	Accumulated depreciation	\$103,000	
	Credit	Asset disposal account	\$103,000

Part exchange allowance:

Debit	Non-current assets at cost	\$21,000	
	Credit	Asset disposal account	\$21,000

Balance of transaction:

Debit	Non-current assets at cost	\$134,000	
	Credit	Trade payables	\$134,000

Note: cost of new asset \$155,000 - part exchange allowance \$21,000.

EXAMPLE 9 – ASSET SCRAPPED

During the year to 30 June, Samantha scrapped an asset which had cost \$23,000. At the date the asset was scrapped, it had accumulated a depreciation of \$20,700. What was the profit or loss on disposal?

First of all, we can observe that this must lead to a loss on disposal, as there are no proceeds. Second, the loss is equal to the net book value at the date of disposal. Thus the loss is \$2,300 (\$23,000 - \$20,700). ■

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