FINANCE FOR MANAGERS
MODULE B103
ASSIGNMENT

Fixed assets

Fixed assets represent the more or less permanent assets of the business. They are not normally for re-sale. Examples include premises, fixtures & fittings, furniture, equipment and motor vehicles.

Investments of a long-term nature may also be included. The purchase of stocks and shares in other companies of property investment are some examples.

These fixed assets are 'tangible' because they can be seen. Some assets are 'intangible' because they cannot be seen. Goodwill is one of the latter and represents the good name or reputation of the business, which could be valuable, if it is sold.

Three examples of fixed assets are:

- Premises or buildings

This is considered to be a fixed asset because it is owned either by the business or by the owner and is of value. Buildings are property and are therefore usually not re-sold; they tend to be more permanent assets to the business.

- Equipment

This is a purchase by the business and can include such things as stationary, machinery and other items relating to the running of the business. The origin of the business and the type of product that it produces will determine what equipment it purchases. A disadvantage is that equipment can be seen to be a minor expense than that of the premises. Therefore, the concept that all equipment are fixed assets can be untrue.

- Motor vehicles

A business may need to purchase vehicles such as lorries or cars so that it can deliver suppliers or stocks. In some businesses, company cars are provided for workers to visit clients, for example. In both cases, maintenance of motor vehicles in necessary, meaning constant checks and repairs, as well as fuel and general running costs. Vehicles are therefore identifies to be fixed assets in a company's financial statements.

Depreciation

Depreciation is the process of allocating in a systematic and rational manner the cost of a capital asset over the period of its useful life. The concept takes into account the decrease in the service potential of capital assets invested in a business venture, resulting from such a number of different causes:

- Wear and tear
- Deterioration
- Erosion
- Obsolescence
- Technological changes
- Introduction of new and better machinery and methods of production

Depreciation is an expense and is a charge against the profits of the business in the profit & loss account.

The cumulative depreciation since acquisition is reported on the balance sheet as a deduction from the cost of the related asset. The difference is referred to as the asset's 'carrying amount' or 'book value'. The periodical depreciation charge enters into the computation of net income.

Three methods of depreciation:
1. Fixed instalment (or straight-line)
2. Reduced balance (or diminishing balance)
3. Revaluation

Once a method is adopted for a particular asset or group of assets, it is regarded as standard accounting practice to consistently apply the same method until the asset or assets are disposed of.

The 'depreciation of fixed assets'

Continuous use of assets them from one accounting period to the next usually means that some of their value is lost because of wear and tear, damage, obsolescence or any other factor which may diminish their worth.

Assets such as premises may increase in value and therefore appreciate. The value of property may be increased under fixed assets and an equivalent increase shown in the 'financed by' section under a capital revaluation account.

The value of premises may well appreciate rather than depreciate over the years. An increase in value may be recorded under fixed assets and the increase also reflected in the 'financed by' section, usually under the heading 'revaluation account'.

In each financial period, the estimated loss in value of a fixed asset is charged against profits and the balance sheet would record their NBV. Depreciation is therefore regarded as an expense to the business and the purchase of fixed assets is like buying an expense charged against profits over periods, until the asset is disposed of.

The Fixed Instalment / Straight-line method

This method charges the same depreciation sum each year against profits. The amount is calculated by firstly dividing the difference between the cost price of an asset and the amount expected to be realised when the item is resold (residual value). This figure is divided by the number of years the business intends to hold the asset.

If an asset is not expected to be resold, annual depreciation is the cost price of an asset divided by the number of years.
Many organisations use this type of depreciation on fixed assets such as furniture, fittings, plant, machinery and equipment.

Advantages:
- Simple & effective method
- Preferred for costing purposes

The Reducing Balance / Diminishing Balance method

An alternative method of depreciation of fixed assets is to ensure that the depreciation charge each year diminishes as the asset gets older and is of less value. The newer the asset, the more should be charged against profits – more value is lost in the earlier years rather than in the later.
This method can be applied by using a fixed percentage rate on the asset's net value each year, thereby effecting a lower depreciation charge each year.

Disadvantage:
This assumed increasing repair cost in the later years caused by the reduced annual charge of depreciation is frequently incorrect.

The Revaluation method

This method of depreciation may be adopted where an annual valuation of certain fixed assets may be assessed on inspection or by recourse to guidelines from a trade handbook.

Hotel and catering trades use this method against items such as crockery and bedding. By apprasing their worth annually, any loss in value is treated as the depreciation charge for the year.

Advantages:
Most convenient for loose tools and patterns
Used by farmers and racing establishments

The disposal of a fixed asset

If an asset is sold for more than its NBV, the gain may be transferred to the Profit & Loss account as 'other revenue'
If it is disposed of at less than its NBV, the loss may be charged against profits as a further expense.

How do the accounting concepts and the FRS and SSAPs relate to the treatment of depreciation?

Statements of Standard Accounting Practice (SSAPs)

SSAPs represent the profession's accounting standards. These statements are prepared for the purpose of standardising the final accounts of a business. Any accountant preparing accounts is obliged to conform to the standards laid down by the profession; otherwise he may be required to explain why he has not done so.

SSAP 12 – *Accounting for depreciation*

The statement concerned with the treatment of depreciation is SSAP No. 12, *Depreciation*. It sets out the rules for depreciating tangible fixed assets that have a finite useful life. Depreciation is required to be charged in the profit and loss account, based on the carrying amount of the asset in the balance sheet, whether at historical cost or revalued amount. It also states that a business should select a method that is 'most appropriate to the type of asset' but lays down no specific guidelines as to *what* method should be adopted.

SSAP 12 is effective for accounting periods starting on or after 1 January 1987.The standard will be superseded shortly by FRS 15 'Tangible Fixed Assets'. The new standard brings together requirements on the initial measurement, valuation and depreciation of tangible fixed assets.

There are some exceptions such as investments, goodwill, and freehold land. Buildings, however, should be depreciated even though their market value may increase. It is still prudent to depreciate buildings because they do deteriorate with time. The straight-line method of depreciation is one of the most appropriate for some types of fixed assets. The standard indicates that a change of method is only acceptable if it is thought that it will give a better or fairer position of the accounts.

Financial Reporting Standards (FRSs)

Accounting standards developed by the ASB are contained in 'Financial Reporting Standards' (FRSs). After the adoption of standards issued by the ASC, FRS's has superseded some of the SSAP's. The statement associated with depreciation of fixed assets is FRS No. 12 Provisions, Contingent Liabilities and Contingent Assets.

FRS No. 15 – *Tangible Fixed Assets*

FRS 15 sets out the principles of accounting for tangible fixed assets and ensures that these assets are accounted for on a consistent basis. The FRS permits a choice as to whether tangible assets are stated at cost or at revalued amount. FRS 15 incorporates many of the requirements of SSAP 12; the FRS recognises that in a limited number of cases, no depreciation charge may be made because it is immaterial. Where this is the case, or where depreciation is calculated on a basis that assumes that the useful life of an asset is longer than fifty years, the standard requires annual impairment reviews. This will ensure that the carrying amount of the asset is not overstated. FRS 15 is effective for accounting periods ending on or after 23 March 2000.