

Lecture 1: Non-Current Assets- Chapter 8

Three primary activities for property, plant and equipment (main non-current assets):

1. Acquisition of non-current assets,
2. Depreciation of non-current assets over their useful lives
3. Disposal of non-current assets

Recording Non-Current Assets

A non-current asset is any tangible resource that is expected to be used in the normal course of operations for more than one year and is **not intended for resale**. Examples include land, buildings, equipment, furniture, fixtures, etc.

Non-current assets should be recorded at the cost of acquiring them, including the:

- purchase price
- taxes and duties paid on the purchase
- fees such as closing costs paid to attorneys
- delivery costs
- insurance costs during transit
- installation costs

Example

Assume Tran Paper Supply buys a delivery truck and pays the following:

Purchase price: \$60 000

Additional import duty: \$3 600

Stamp duty: \$400

GPS system: \$1 000

Non-compulsory (don't include) insurance: \$1 400

The entry to record the purchase of the truck is:

General Journal					
Date	Description	Debit	Credit		
(Date)	Delivery truck	65 000			
	Cash		65 000		

Assets	=	Liabilities	+	Equity
+65 000				
-65 000				

Expensing Non-Current Assets

- A non-current asset converts to an expense as it is used or consumed.
- The expensing of non-current assets is accomplished through depreciation.
- Depreciation is the process of allocating the cost of a non-current asset over its useful life.
- Depreciation is an application of the matching principle; because a non-current asset is used to generate revenues period after period, some of its cost should be expensed in, or matched to, those same periods.

For accounting purposes, depreciation is a process of allocating an asset's cost, not a method of determining an asset's net realisable or market value – depreciation is NOT about getting an asset to its' market value!

E.g. you buy a pair of shoes for \$200 expecting to wear them 200 times, expecting them to be worthless after this usage. After you wear them once, they might have a net realisable value (NRV) of \$100 (smelly feet, creases, etc!), but depreciation might only be \$1 if it's based on "use"!

Recording Depreciation

- Depreciation expense is normally calculated at the end of an accounting period and recorded with an adjusting journal entry.
- The general form of the entry to record depreciation is:
 - o Debit depreciation expense (expense increasing)
 - o Credit accumulated depreciation (contra asset increasing)
- Accumulated depreciation is a contra-asset account, meaning that it sits just below the current asset, and its accumulating balance is subtracted from the non-current asset account to yield the carrying amount (net book value) of the non-current asset – carrying amount gets lower over time.
- Like other expenses, depreciation expense is reported on the statement of comprehensive income, often as a separate line item.

Calculating Depreciation Expense

- When a company owns depreciable assets, it must calculate depreciation expense each period.
- Doing so requires the following information about the asset:
 - o cost (usually what you bought it for – historical cost)
 - o residual or salvage value (what you think you will sell it for, when you do)

- o useful life (how long you will keep it)
- o depreciation method (how you are going to spread its cost over its life)

Straight Line Method

- The depreciable cost of the asset is divided by the useful life of the asset (in years) to yield the amount of depreciation expense per period.

Straight-line depreciation

Assume that Tran's truck purchased on 1/7/2012 for \$65,000 has a salvage value of \$15 000 and a 5-year life or 100 000 Km. Using straight-line depreciation, Tran would record \$10 000 per year [or $(\$65\ 000 - 15\ 000) \div 5 = \$10\ 000$].

General journal

Date	Description	Debit	Credit
2013 30 June	Depreciation expense	10 000	
	Accumulated depreciation—Truck		10 000

Assets	=	Liabilities	+	Equity
-10 000				-10 000

Straight-line depreciation example

Year	Calculation	Depreciation expense	Accumulated depreciation	Carrying amount
			\$ 0	\$65 000
2013	$(\$65\ 000 - \$15\ 000) / 5$	\$10 000	\$10 000	\$55 000
2014	$(\$65\ 000 - \$15\ 000) / 5$	\$10 000	\$20 000	\$45 000
2015	$(\$65\ 000 - \$15\ 000) / 5$	\$10 000	\$30 000	\$35 000
2016	$(\$65\ 000 - \$15\ 000) / 5$	\$10 000	\$40 000	\$25 000
2017	$(\$65\ 000 - \$15\ 000) / 5$	\$10 000	\$50 000	\$15 000

On the above depreciation schedule, notice how the straight-line method:

- shows the same depreciation every year
- accumulated depreciation grows \$10 000 yearly until the balance equals the depreciable cost of the asset
- net book value decreases \$10 000 yearly until it equals the salvage value estimated for the asset

Reducing Balance Method

- The reducing-balance method of depreciation is an accelerated method that results in more depreciation expense in the early years of an asset's life and less depreciation expense in the later years.
- Accelerated depreciation methods may match expenses to revenues better than the straight-line method. More depreciation expense is recorded when the asset is more useful in its early years.
- They provide larger expenses (and if used for tax purposes larger tax deductible expenses) in earlier years of a non-current asset's life.

$$1-n \sqrt{\frac{\text{Residual value}}{\text{Cost}}}$$

- Where n = number of periods
- For simplicity we use 2 times the straight-line rate.
- This often means the last depreciation expense calculation is to reduce the book value to the residual value.

Units of Activity Method

- The units-of-activity method of depreciation calculates depreciation based on use.
- Because it relies on an estimate of an asset's lifetime activity, the method is limited to assets whose units-of-activity can be in some way determined.
- Depreciation per unit of expected activity is the depreciable cost of the asset divided by the estimated units-of-activity over the life of the asset.

LO3: Adjustments

Adjustments are needed if there is a reassessment of the length of time the asset will remain useful, or the value of the asset at the end of its useful life or because money is spent on the asset to maintain or improve its operating capacity

Since non-current assets are used for multiple years, companies sometimes need to make adjustments as new information is available or as new activity occurs.

These adjustments can arise from the following:

- changes in estimates
- additional expenditures to improve the non-current asset
- significant declines in the asset's net realisable value

Changes in depreciation estimates

Matthew purchases a machine for \$90 000 on 1/7/2010, with a 10 year useful life and \$10 000 residual value. Using straight-line, Matthew records \$8 000 depreciation expense each year.

Date	Description	Debit	Credit
2013 30 June	Depreciation expense	8 000	
	Accumulated depreciation—machine		8 000

Assets	=	Liabilities	+	Equity
-8 000				-8 000

Expenditures after Acquisition

Most non-current assets require expenditures throughout their useful lives. The accounting treatment for expenditures made during the useful life of a non-current asset depends on whether they are classified as 'capital' or 'revenue' expenditures.

A capital expenditure increases the expected useful life or productivity of the asset. Revenue expenditure maintains the expected useful life or productivity of the asset.

Capital expenditure

A company purchases a non-current asset for \$50 000 on 1/1/2013, with a five-year life and no residual value. During the fifth and final year of the asset's life, the company incurs \$8 000 for upgrades that extend the asset's life to 7 years, from 5.

Date	Description	Debit	Credit
Year 5	Non-current asset	8 000	
	Cash		8 000
	(To record upgrade to asset)		

Assets	=	Liabilities	+	Equity
+8 000				
-8 000				

Change in depreciation due to capital expenditure

Step 1	<u>Calculate net book value after capital expenditure:</u>	
	Cost of the asset, 1 July, 2010	\$50 000
	Less: <u>Accum depn</u> for four years	\$40 000
	Net book value on 1 July, 2014	\$10 000
	Plus: Upgrades made in 2014	\$ 8 000
	Updated Carrying Amount for 2014	\$18 000
Step 2	<u>Calculate depreciable expense:</u>	
	Updated book value for 2014	\$18 000
	Less: Estimated salvage value	\$ 0
	Remaining depreciable cost	\$18 000
	Divided by remaining useful life	÷ 3
	Annual depreciation expense	\$ 6 000

Revenue expenditure

A company purchases a non-current asset for \$50 000 on 1/7/2010, with a five-year life and no residual (salvage) value. During the fifth and final year of the asset's life, the company incurs \$1 000 in ordinary maintenance.

General journal

Date	Description	Debit	Credit
Year five	Maintenance expense	1 000	
	Cash		1 000
	(To record normal maintenance)		

Assets	=	Liabilities	+	Equity
-1 000				-1 000

Asset Impairment

- When a non-current asset's recoverable amount falls below its carrying amount, the asset is considered impaired.
- Under AASB 136 entities apply conservatism by writing these assets down from their carrying amount to their recoverable amount (through use or sale).
- Normally any loss on impairment is an expense.
- Special rules apply to impairment of assets previously revalued and reversal of impairments.

LO4: Disposals

The accounting for the disposal of a non-current asset consists of the following three steps:

1. Update depreciation on the asset.
2. Calculate gain or loss on the disposal.
3. Record the disposal.

Rule for calculating the gain or loss on disposal

1. Record any necessary depreciation expense (possibly for a partial period) to update the accumulated depreciation account.
2. Calculate any gain or loss on the disposal by comparing the asset's carrying amount.
3. Prepare a journal entry that decreases the asset account and its related accumulated depreciation account.
4. Record any gain or loss on the disposal.

LO5: Intangible Assets

An intangible asset is a resource that is used in operations for more than one year but has no physical substance. Examples include patents, trademarks, copyrights, franchises, and goodwill.

“Amortising” intangible assets – like depreciation, just a different word!

A company holds a \$60 000 patent that has the maximum legal life of 20 years. The company estimates the patent will be useful for only 12 years and will then be worthless. How do we record amortisation?

$$\$60\,000 \div 12 = \$5\,000 \text{ per year}$$

General journal

Date	Description	Debit	Credit
End of year	Amortisation expense	5 000	
	Patent		5 000

Assets	=	Liabilities	+	Equity
-5 000				-5 000

Recording Goodwill

Goodwill is created when one company buys another company and pays more than the value of the net assets of the purchased company.

Suppose that Buyer Company purchases Seller Company for \$8 million when the value of Seller Company's net assets is \$6 million. How will this be recorded?

Recording goodwill (2)

General journal				
Description		Debit	Credit	
Net assets of seller company		6 000 000		
Goodwill		2 000 000		
Cash			8 000 000	

Assets	=	Liabilities	+	Equity
+6 000 000				
+2 000 000				
-8 000 000				

The premium paid for goodwill is usually due to the acquired company's customers, its reputation, its employees, its market share, or its research.

Lecture 2: Partnerships- Financial Ch 10

- An association of two or more persons carrying on a business with a view to profit.
- If you are a social enterprise, third sector, not-for-profit entity, you cannot structure as a partnership (Barron, et al, Chapter 19)
- A partnership combines:
 - o capital
 - o talent
 - o experience

Common-Law Rules

- **Intention:** Do the persons in question intend to be partners? If they do, they may be legally classed a partnership though not incorporated.
- **Agency:** Each party can make decisions on behalf of other parties
- **Sharing profits** (losses)

Statutory Rules:

- Joint ownership of property
- Sharing of gross returns
- Receiving a share of partnership profits (but there are exceptions)
- Partnerships can be formed by verbal agreement – by estoppel

Accounting for Partnerships

Because a partnership is a pass-through entity, each partner reports his or her share of the partnership's income or loss as an individual. As a result, the accounting treatment is very much like a sole trader. To keep track of information, each partner will have (1) a capital account, and sometimes, (2) a drawing account.

A 'capital' account for each partner

- For a sole trader all contributions and any drawings are between the business entity and the single owner. But for a partnership, each partner may contribute different assets (and liabilities) and withdraw different amounts at different times.
- To keep track of these, each partner is given their own partnership capital account.
- In some cases a 'current' account is also used for day to day movements in partner's capital.

Capital account for each partner

- The capital account for each partner records the fair value of the net assets contributed.
- While partnerships are sometimes formed from the existing businesses of the partners, the recorded value of those items in the books of the former businesses is not relevant.
- Accumulated depreciation is not brought into the accounts (books) of the new partnership. But 'provision for bad debts' is usually recorded because we know who owes what, but we do not know who will not pay.

Recording partnership commencing

Assume Emily and Paul each contribute \$10 000 cash to commence a partnership (this is like the original transaction to commence a business except we now have two owners)

General journal

Date	Description	Debit	Credit
2013 1 July	Cash	20 000	
	Emily, capital		10 000
	Paul, capital		10 000

Recording partnership commencing (2)

Assume Emily contributes: cash \$194, accounts receivable \$120 (probably won't collect \$20 of this), equipment (net) \$205 and a note payable \$200.

General journal

Date	Description	Debit	Credit
2013 1 July	Cash	194	
	Accounts receivable	120	
	Equipment	205	
	Allowance for BD		20
	Note payable		200
	Emily, capital		299

LO3 Allocating profits and losses

- Each partner must be satisfied with the allocation of profits and losses otherwise they would not join the partnership
- Unlike a sole proprietorship where all the rewards from all the contributions go to the one owner, in a partnership each partner usually contributes different resources and skills and would like to be rewarded for each of them. These include:
 - o The amount of capital invested.
 - o The amount of labour contributed.
 - o Other factors brought to the partnership such as an ability to attract clients/customers etc.
- The partnership agreement needs to be precise in defining the allocation of profits and losses.
- If \$100 000 is to be based on service, but there is a loss, does that mean there is no reward for service, and loss is shared as per the agreement on sharing residual?
- E.g. A & B are partners they share the first \$100 000 based on service. "A" performs 70% of the total service. The next \$100 000 is shared based on capital, "A" contributed \$3m and "B" \$2m. Remaining profits (or losses) are shared equally.