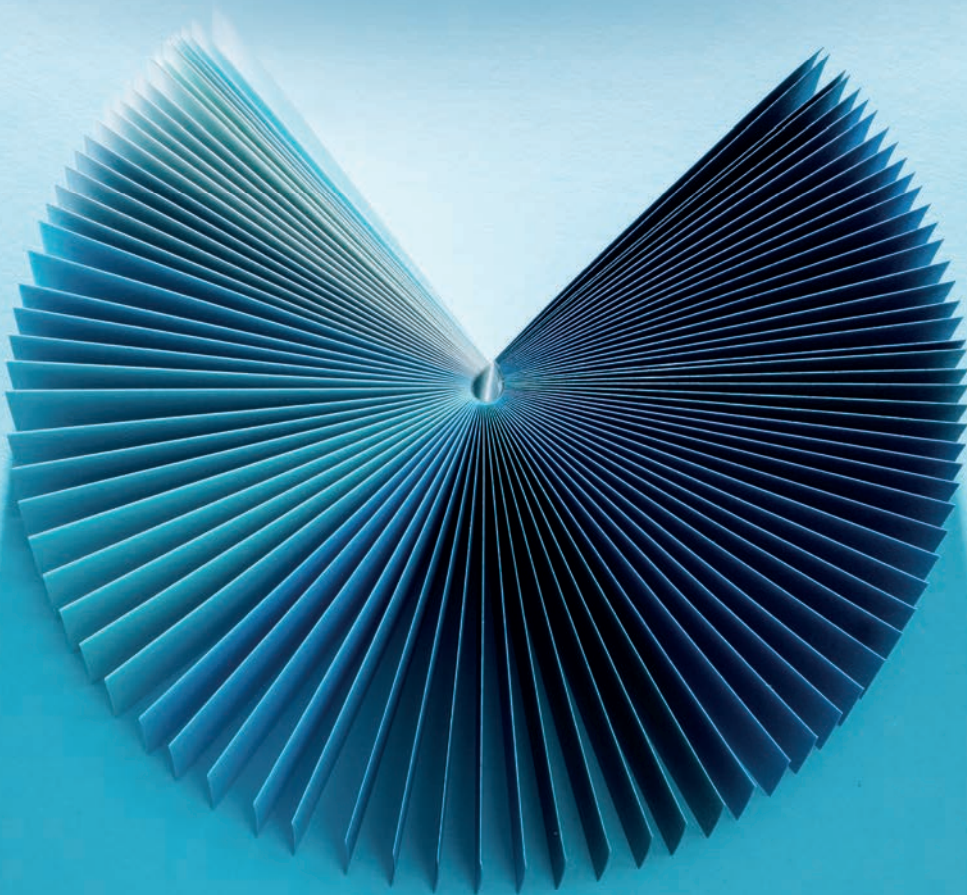


# Financial and Management Accounting

## An introduction

Pauline Weetman



EIGHTH EDITION

# FINANCIAL AND MANAGEMENT ACCOUNTING

## AN INTRODUCTION

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**Table 8.6** The Removals Company statement of financial position (balance sheet) at end of Year 3 and Income statement (profit and loss account) for Year 3

The Removals Company Statement of financial position (balance sheet) at 31 December Year 3				£
<b>Non-current (fixed) assets</b>				
	Furniture van at cost			60,000
	Accumulated depreciation			(36,000)
	Net book value			<u>24,000</u>
<b>Current assets</b>				
	Cash			<u>124,000</u>
	Total assets			<u>148,000</u>
<b>Ownership interest</b>				
	Ownership interest at the start of the year			104,000
	Profit of the year			<u>44,000</u>
				<u>148,000</u>

The Removals Company Income statement (profit and loss account) for the year ended 31 December Year 3				£	£
<b>Revenue</b>					
	Fees for removal work				120,000
<b>Expenses</b>					
	Wages, fuel and other running costs	(58,000)			
	Depreciation	(18,000)			
					<u>(76,000)</u>
	Net profit				<u>44,000</u>

**Table 8.7** Spreadsheet analysis of transactions of The Removals Company, Year 4

	Transaction or event	Assets			Ownership interest		
		Van at cost	Accumulated depreciation of van	Cash	Ownership interest at start of year	Capital contributed or withdrawn	Profit = revenue minus (expenses)
Year 4		£	£	£	£	£	£
1 Jan.	Amounts brought forward at start of year	60,000	(36,000)	124,000	148,000		
All year	Collected cash from customers			120,000			120,000
All year	Paid for wages, fuel, etc.			(58,000)			(58,000)
31 Dec.	Calculate annual depreciation		(18,000)				(18,000)
	Totals	60,000	(54,000)	186,000	148,000		44,000
		└────────── 192,000 ─────────┘			└────────── 192,000 ─────────┘		

The disposal of the van must be analysed in stages:

- 1 collecting cash;
- 2 transferring ownership of the vehicle;
- 3 removing the vehicle from the accounting records.

**Table 8.8** Spreadsheet analysis of transactions of The Removals Company, Year 4, including sale of non-current (fixed) asset

	Transaction or event	Assets			Ownership interest		
		Van at cost	Accumulated depreciation of van	Cash	Ownership interest at start of year	Capital contributed or withdrawn	Profit = revenue minus (expenses)
Year 4		£	£	£	£	£	£
1 Jan.	Amounts brought forward at start of year	60,000	(36,000)	124,000	148,000		
All year	Collected cash from customers			120,000			120,000
All year	Paid for wages, fuel, etc.			(58,000)			(58,000)
31 Dec.	Calculate annual depreciation		(18,000)				(18,000)
31 Dec.	Van disposal	(60,000)	54,000	6,000			
	Totals	nil	nil	192,000	148,000		44,000
		192,000			192,000		

When the vehicle is removed from the record, two columns must be reduced to zero. These are the *van at cost* column and the *accumulated depreciation* column. The van at cost column shows the original cost of £60,000 and the accumulated depreciation shows the amount of £54,000 which has to be deducted to show the amount of the net book value. The asset of cash increases by £6,000. In terms of the accounting equation:

Assets	–	Liabilities	=	Ownership interest
		no change		no change
Increase in cash				
Decrease van:				
At cost				
Accumulated depreciation				

The resulting statement of financial position (balance sheet) and income statement (profit and loss account) are shown in Table 8.9.

The Removals Company			£
Statement of financial position (balance sheet)			
at 31 December Year 4			
			£
<b>Non-current (fixed) assets</b>			Nil
<b>Current assets</b>			
Cash			192,000
Total assets			<u>192,000</u>
<b>Ownership interest</b>			
Ownership interest at the start of the year			148,000
Profit of the year			<u>44,000</u>
			<u>192,000</u>

The previous illustration was based on selling the van for £6,000, an amount equal to the net book value. Suppose instead it was sold for £9,000. There is a gain on disposal of £3,000. This gain is reported in the income statement (profit and loss account).

If the amount of the gain or loss on disposal is relatively small, it may be deducted from the depreciation charge. In that situation the income statement (profit and loss account) would appear as shown in Table 8.10 where bold printing highlights the difference when compared with the income statement (profit and loss account) in Table 8.9. If the gain or loss is **material** it will be reported separately.

**Table 8.10** Income statement (profit and loss account) for Year 4 when proceeds of sale exceed net book value of non-current (fixed) asset

The Removals Company Income statement (profit and loss account) for the year ended 31 December Year 4			
	£		£
<b>Revenue</b>			
Fees for removal work			120,000
<b>Expenses</b>			
Wages, fuel and other running costs	(58,000)		
Depreciation (18,000 – 3,000)	<u>(15,000)</u>		
			<u>(73,000)</u>
Net profit			<u>47,000</u>

### 8.8.6 A table of depreciation expense

To test your understanding of the impact of depreciation you may wish to use a table of the type shown in Table 8.11. It shows that, whatever the proceeds of sale of the asset, the total expense in the income statement (profit and loss account) will always be the same but the amount of expense each year will vary.

If you compare the two tables (a) and (b) you will see that:

- total depreciation over the three years is the same in both cases;
- total net profit after depreciation over the three years is the same in both cases;
- annual depreciation in Years 1 and 2 is lower in table (b);
- net profit after depreciation in Years 1 and 2 is higher in table (b);
- net book value of the asset at the end of Years 1 and 2 is higher in table (b);
- the depreciation charge in Year 3 is higher in table (b);
- the net profit after depreciation in Year 3 is lower in table (b).

This is an example of what is referred to in accounting as an **allocation** problem (a 'sharing' problem). The expense is the same in total but is allocated (shared) differently

**Table 8.11** Table of depreciation charge

(a) A van cost £60,000, was estimated to have a useful life of three years and a residual value of £6,000. It was sold for £9,000 on the last day of Year 3. Net profit before depreciation is £62,000.					
Year	Net profit before depreciation	Depreciation expense of the year	Net profit after depreciation	Cost less accumulated depreciation	Net book value
	£	£	£	£	£
1	62,000	18,000	44,000	60,000 – 18,000	42,000
2	62,000	18,000	44,000	60,000 – 36,000	24,000
3	62,000	<u>15,000</u>	<u>47,000</u>	60,000 – 54,000	6,000
Total depreciation charge		<u>51,000</u>			
Total reported net profit			<u>135,000</u>		
Proceeds of sale exceed net book value by £3,000. This gain is deducted from the depreciation expense of £18,000 leaving £15,000 as the expense of the year.					

Table 8.11 (Continued)

(b) A van cost £60,000, was estimated to have a useful life of three years and a residual value of £9,000. The annual depreciation was calculated as £17,000. The van was sold for £9,000 on the last day of Year 3. Net profit before depreciation is £62,000.

Year	Net profit before depreciation	Depreciation expense of the year	Net profit after depreciation	Cost less accumulated depreciation	Net book value
	£	£	£	£	£
1	62,000	17,000	45,000	60,000 – 17,000	43,000
2	62,000	17,000	45,000	60,000 – 34,000	26,000
3	62,000	<u>17,000</u>	<u>45,000</u>	60,000 – 51,000	9,000
Total depreciation charge		<u>51,000</u>			
Total reported net profit			<u>135,000</u>		

Net book value equals proceeds of sale so the depreciation charge of Year 3 is the same as that of previous years.

across the years of the asset's life. As a result, there are different amounts in the income statement (profit and loss account) for each year but the total profit over the longer period is the same.

### 8.8.7 Impairment

An asset is impaired when the business will not be able to recover the amount shown in the statement of financial position (balance sheet), either through use or through sale. If the enterprise believes that impairment may have taken place, it must carry out an **impairment review**. This requires comparison of the net book value with the cash-generating ability of the asset. If the comparison indicates that the recorded net book value is too high, the value of the asset is reduced and there is an expense in the income statement (profit and loss account).<sup>8</sup>

The impairment test may be applied to intangible non-current (fixed) assets such as goodwill, in order to justify non-amortisation. If no impairment is detected it may be argued that the asset has maintained its value and so amortisation is not necessary. If there has been impairment of the historical cost net book value, then the loss in asset value becomes an expense for the income statement (profit and loss account).

#### Activity 8.8

A business director argues that estimating the residual value does not matter because the total depreciation over the asset life is the same, regardless of the amount of residual value. How would you reply to that opinion?

#### Self test

**A8.14** Why does the net book value of a non-current (fixed) asset not always equal the proceeds of sale?

**A8.15** Why is depreciation said to cause an allocation problem in accounting?

**A8.16 [S]** What are the matters of judgement relating to non-current (fixed) assets which users of financial statements should think about carefully when evaluating financial statements?

**A8.17** What is meant by impairment?



## 8.9 Summary

- A **non-current asset** is any asset that does not meet the definition of a current asset.<sup>9</sup> Non-current assets include tangible, intangible and financial assets of a long-term nature. These are also described as **fixed assets**.
- **Tangible non-current (fixed) assets** such as property, plant and equipment are assets that have physical substance and are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes on a continuing basis in the reporting entity's activities.
- An **intangible asset** is an identifiable non-monetary asset without physical substance.
- Users need information about the cost of an asset and the aggregate (accumulated) depreciation as the separate components of net book value. Having this detail allows users to estimate the proportion of asset life remaining to be used. This information will be reported in the notes to the statement of financial position (balance sheet).
- Users also need information about the accounting policy on depreciation and its impact on the reported asset values. This information will be found in the notes to the accounts on accounting policies and the notes. There may also be a description and discussion in the strategic report including a forward-looking description of intended capital expenditure.
- **Depreciation** is estimated for the total life of the asset and then allocated to the reporting periods involved, usually annual reporting. No particular method of depreciation is required by law. Preparers of financial statements have to exercise choices. Companies in the UK commonly use straight-line depreciation. An alternative is reducing-balance depreciation. This is found more commonly in some other countries. Choice of depreciation method affects the comparability of profit.

### Further reading

The following standards are too detailed for a first level course but the definitions sections may be helpful:

IASB (2018), IAS 38, *Intangible Assets*, International Accounting Standards Board.

IASB (2018), IAS 16, *Property, Plant and Equipment*, International Accounting Standards Board.

## Questions

Each chapter has three types of question. The 'A' series of 'Self-test' questions are placed at the end of each section to help you test your understanding and review your reading. You will find the answers to these questions by re-reading and thinking about the section. 'Application' questions to test your ability to apply technical skills are in the 'B' series of questions. Questions requiring you to show skills in problem solving and evaluation are in the 'C' series of questions. A letter [S] indicates that there is a solution at the end of the book.