IT IS ESSENTIAL TO READ THESE ARTICLES !!

FR    F7    This is the official ACCA Syllabus guide and study guide designed to help with planning study and provide detailed info on what could be assessed in exam.

IAS 16. Financial Statements & Tangible Fixed Assets

A). define and compute the initial measurement of a fixed asset, (incl self constructed).

B). identify subsequent expenditure that may be capitalised, (incl borrowing costs), distinguishing between capital and revenue items.

C). discuss the requirements of relevant accounting standards in relation to the revaluation of fixed assets.

D). accounts for revaluation and disposal gains / losses for fixed assets.

E). compute depreciation based on cost and revalued amounts and on assets that have two or more significant parts, (complex assets).

Gareth Owen. “Testing, Testing, One, Two, Three"

Refers to the 3 intellectual levels required to study the ACCA syllabus, and a big reason why students are being failed at level two and three !


Examiners interpretation of the impact of a transfer of excess depreciation on the revaluation of an asset


Past exam questions: (go to acca website for question and answer and marking guide).

Financial Reporting (Int'l) 9th December 2008  Q5: NCA Accounting for a 3 year period including a change in UEL  (10 marks)

Problem areas: not knowing difference between revenue and capital expenditure.

General examiner's notes on technique: poor handwriting, not answering question being asked, workings not referenced, ignoring easy marks, poor time management, not answering all the question.

Question 5 examiner’s report !
This question was rather better answered than the equivalent question of recent diets, although a significant number did not attempt it. This was possibly a timing issue, it being the last question. The question gave details of the purchase of a machine with related expenditures and its estimated life expressed in machine hours.

Candidates had to identify which related expenses should be capitalised and which should be expensed. Most candidates did reasonably well on this question, but common errors were:

- treating an early settlement discount as a reduction of cost rather than discounts received
- failing to deduct the residual value before calculating the machine hour depreciation
- even when items where correctly excluded from the cost of the asset, candidates often forgot to include them in the income statement thus missing out on some easy marks

During year three there was additional expenditure on the machine and revisions to its estimated residual value and life. Most candidates that got this far correctly identified the expenditure as an improvement (and capitalised it) and also correctly accounted for the revisions.

Past exam question: (go to acca website for question and answer and marking guide).

Financial Reporting (Int'L) June 2009  Q5:

Depreciate the separate components of a complex asset, (aircraft) dealing with different methods of depreciation, and distinguishing between capital and revenue expenditure.

Question Five: examiner’s report !
This question required candidates to depreciate the separate components of a ‘complex’ asset (an aircraft) dealing with different methods of depreciation and distinguishing between capital and revenue expenditures.

A significant number of candidates did not start this question and many more that did appeared to run out of time. There were no general issues here with candidates not understanding what they were meant to do or not reading the requirements properly, however many answers lacked a methodical approach meaning they got hopelessly lost in the detail. Generally the exterior
structure of the aircraft was dealt with correctly although many capitalised the repainting costs (which is revenue expenditure). For the cabin fittings, the upgrade was often correctly capitalised but then the depreciation was calculated on (total) cost, not the new carrying amount and also over the wrong period. The engines caused the most problems. Candidates often tried to perform the calculations of them together, instead of separating them, and then became confused in what they were doing.

IT IS ESSENTIAL TO READ THESE NOTES B4 THE CLASS !!

**Objective of IAS 16 PPE**: Prescribe the accounting treatment for property, plant, and equipment. (PPE)

PPE are tangible assets held by an entity for more than one accounting period for use in production & supply of goods and services, for rental or for office use.

- recognition of assets
- determination of carrying amounts
- depreciation charges and impairment losses to be recognised

**Scope**: IAS 16 does not apply to assets classified as held for sale (IFRS 5)

**Recognition**: recognise assets in SoFP when:

- It is probable that future economic benefits will flow to the entity from that asset
- cost of the asset can be measured reliably.

Recognition principle is applied to all PPE costs as they are incurred. Initial cost to acquire or construct an asset, subsequent expenditure on additions, replacements or servicing.

IAS 16 recognises that parts of some assets may require replacement at regular intervals. (complex assets / aircraft engines) The carrying amount of this asset will include the cost of replacing that part when that cost is incurred if the recognition criteria are met.(future benefits and measurement reliability)

Also, continued operation of an asset may require regular inspections, this cost is recognised in the carrying amount of PPE as a replacement cost (if recognition criteria are satisfied)
**Separate Components:**
A complex asset is an asset that has separate components within a single asset, aircraft, each separate part should be depreciated over their UEL.

Major inspection or Overhaul: these are usually expensed as incurred. But, they are capitalised as NCA if they satisfy IAS 16 separate components, and depreciated over UEL.

Separate Components: Illustration: Question: Overhaul costs:
An entity buys an aircraft that has expected UEL of 20 years with no residual value. The aircraft requires substantial overhauls at the end of years 5, 10, 15. The aircraft cost £25m and £5m of this is estimated to be attributable to the economic benefits that are restored by the overhauls.

Required: Calculate annual depreciation charge for years 1-5, and 6-10.

Separate Components: Illustration: Answer: Overhaul costs:
The aircraft is treated as two separate components for depreciation purposes.

<table>
<thead>
<tr>
<th>Years 1-5</th>
<th>£m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial £5m depreciated over 5 years</td>
<td>1</td>
</tr>
<tr>
<td>Balance of £20m depreciated over 20 years UEL of aircraft</td>
<td>1</td>
</tr>
<tr>
<td>Depreciation charge p/a</td>
<td>2</td>
</tr>
</tbody>
</table>

When the first overhaul is completed at end of year 5 at a cost of SAY £6m, this cost is capitalised and depreciated over to the date of the next overhaul.

<table>
<thead>
<tr>
<th>Year 6-10</th>
<th>£m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overhaul £6m depreciated over 5 years</td>
<td>1.2</td>
</tr>
<tr>
<td>Aircraft depreciation</td>
<td>1</td>
</tr>
<tr>
<td>Depreciation charge p/a</td>
<td>2.2</td>
</tr>
</tbody>
</table>
**Initial Measurement :**

PPE should initially be measured at cost, include all costs necessary to bring asset to working condition, original purchase price, site preparation, delivery, installation, if the entity constructed the asset then they might incur other costs that may be included: Materials, labour, overheads, professional architect’s and engineer’s fees, and estimated costs of dismantling and removing the asset and restoring the site (IAS 37).

Revenue costs should be written off as incurred.

**Initial Measurement: Illustration:**

An entity started construction on a building for its own use on (01/04/07) incurred the following costs:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price of land</td>
<td>£250,000</td>
</tr>
<tr>
<td>Stamp duty (land tax)</td>
<td>£5,000</td>
</tr>
<tr>
<td>Legal fees</td>
<td>£10,000</td>
</tr>
<tr>
<td>Site preparation and clearance</td>
<td>£18,000</td>
</tr>
<tr>
<td>Materials</td>
<td>£100,000</td>
</tr>
<tr>
<td>Labour (01/04/07 to 01/07/08)</td>
<td>£150,000</td>
</tr>
<tr>
<td>Architect’s fees</td>
<td>£20,000</td>
</tr>
<tr>
<td>General overheads</td>
<td>£30,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>£583,000</strong></td>
</tr>
</tbody>
</table>

Relevant info: material costs were greater than expected, it was found that materials costing £10,000 had been spoiled and therefore wasted, and a further £15,000 was incurred as a result of faulty design work. As a result of these problems work on the building stopped for two weeks during October 2007 and it is estimated that £9,000 of the labour costs relate to this period.

The building was completed on 01/07/2008 and occupied on 01/09/2008.

**Required:** calculate the costs of the building that will be included in tangible non-current asset as an addition.

**Answer:**

Only those costs which are directly attributable to bringing the asset into working condition for its intended use should be included:

- Admin and other general overheads cannot be included.
- Only include normal costs, not abnormal costs.
- The costs of spoiled materials and faulty designs are abnormal costs.
- The £9,000 labour cost incurred during the stoppage as an abnormal cost and is excluded.

<table>
<thead>
<tr>
<th>Amount to be include in PPE</th>
<th>Total</th>
<th>Exclude</th>
<th>Include</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price of land</td>
<td>250,000</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td>Stamp duty (land tax)</td>
<td>5,000</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Legal fees</td>
<td>10,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Site preparation &amp; clearance</td>
<td>18,000</td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td>Materials</td>
<td>100,000</td>
<td>25,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Labour</td>
<td>150,000</td>
<td>9,000</td>
<td>141,000</td>
</tr>
<tr>
<td>Architect’s fees</td>
<td>20,000</td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>General overheads</td>
<td>30,000</td>
<td>30,000</td>
<td></td>
</tr>
</tbody>
</table>
**Subsequent Expenditure:**
Should only be capitalised if it results in the total economic benefits expected from the asset to increase above those expected on original recognition, more / improved production capacity, eg, cost of an extension should be capitalised as capital expenditure(capex) because economic benefits will increase with more space.

All other subsequent expenditure goes to SOCI because it only maintains (maintenance) the economic benefits, a general repair, revenue expenditure, expensed

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**Subsequent Expenditure: Illustration: Question:**
A piece of machinery has an annual service costing £10,000. During a recent service it was decided to replace part of the engineering meaning it will work faster and produce more units p/hour. The cost of the replacement is £20,000

**Subsequent Expenditure: Illustration: Answer:**
£10,000 servicing cost is revenue expenditure, write off, expensed to SOCI
£20,000 replacement part enhances future economic benefits and so is capex, increase cost of NCA in SOFP

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**Subsequent Expenditure: Illustration: Question:**
In each of the following cases justify whether or not the expenditure should be capitalised:

A). a new engine is fitted to a machine increasing production form 100,000 to 140,000 units p/a
B). Replacement of rotting windows in head office
C). replacement of an aircraft engine every 5 years

**Subsequent Expenditure: Illustration: Answer:**
A). this expenditure enhances the economic benefits of the machine by increasing productivity, should be capitalised.

B). difficult to argue that replacement windows enhances economic benefit of head office, thus revenue expenditure written off to SOCI

C). engine of an aircraft is likely to be a separate component asset of the aircraft because it's economic life will be substantially less than the aircrafts itself. Engine should be depreciated over five years and cost of replacement engine will be capitalised every 5 years
Measuring Revaluations of NCA: IAS 16 allows two accounting models:

- Cost Model. Asset is carried at (cost - accumulated depreciation and impairment).
- Revaluation Model. Asset is carried at revalued amount, its fair value (FV) at the date of revaluation less subsequent depreciation and impairment, provided that FV can be measured reliably.

If the Revaluation Model is adopted then 2 conditions must be satisfied:

- Revaluations carried out regularly, so that the carrying amount of an asset does not differ materially from its FV at reporting date.
- If an item is revalued, the entire class of assets to which that asset belongs should be revalued.

Measuring Revaluations of NCA: Illustration: Accounting for Revaluations:

1). First … Restate asset from cost to revaluation
2). Then … Remove existing accumulated depreciation provision
3). Then … Include carry value increase in revaluation reserve (part of Equity in Capital Account in SoFP)

Journals

<table>
<thead>
<tr>
<th>DR</th>
<th>Description</th>
<th>Debit Credited Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1).</td>
<td>NCA cost / valuation</td>
<td>(Revalued amount - cost) x</td>
</tr>
<tr>
<td>2).</td>
<td>Accumulated Depreciation</td>
<td>Eliminate all of existing depn provision x</td>
</tr>
<tr>
<td>3).</td>
<td>Revaluation reserve</td>
<td>(Valuation - previous CV) x</td>
</tr>
</tbody>
</table>

If a revaluation results in an increase in value, CR Other Comprehensive Income and accumulate the increase in Equity under the heading "Revaluation Reserve".

If the revaluation reverses a revaluation decrease (Dr expense) of the same asset previously recognised as an expense, then it should be recognised as income (CR income). So (DR expense becomes CR income).

A revaluation decrease should be recognised as an expense DR to the extent that it exceeds any amount previously credited to the revaluation surplus relating to the same asset. So (use up any reval credited to reval reserve first then expense the rest of the decrease).

When a revalued asset is disposed of, any revaluation surplus may be transferred directly to retained earnings, or it may be left in equity under the heading revaluation surplus. The transfer to retained earnings should not be made through the income statement (no "recycling" through profit or loss).

(practice T accounts here)
Depreciation on Revalued Assets:

- Revalued assets are depreciated in the same way as under the cost model.
- The depreciation charge on revalued asset should be calculated on the carrying amount of asset (the revalued amount) and all charged to the SOCI.
- A transfer may be made from reval res to retained earnings of the extra depn charge arising from the reval.
- Measured as the difference between the depn charge on the reval amount and the original cost.
- This represents the amount of the reval surplus realised during the period.

Depreciation on Revalued Assets: Illustration:

A company revalued its land & buildings at start of year to £10m (£4m for land).
The property cost £5m (£1m for land) ten years prior to revaluation.
UEL of 50 years in unchanged.
The company’s policy is to make an annual transfer of realised amounts to retained earnings.

Required: show the effects of the above on the financial statements for the year.

<table>
<thead>
<tr>
<th>Land &amp; Buildings (cv)</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>b/f</td>
<td>4,200</td>
</tr>
</tbody>
</table>

| Revaluation           | 5,800 |
| Valuation             | 10,000|
| Depn (6m/40 years)    | (150) |

| c/f                   | 9,850 |

<table>
<thead>
<tr>
<th>Other Comprehensive Income - extract</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on property revaluation</td>
<td>5,800</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of Changes in Equity - Revaluation Surplus</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>b/f</td>
<td>0</td>
</tr>
<tr>
<td>Comprehensive Income for the year</td>
<td>5,800</td>
</tr>
<tr>
<td>Transfer to retained earnings (150 - 4/50)</td>
<td>(70)</td>
</tr>
<tr>
<td>c/f</td>
<td>5,730</td>
</tr>
</tbody>
</table>

Steve Scott has recently posted this on the ACCA website: THEREFORE ESSENTIAL READING!
**Examiners interpretation of the impact of a transfer of excess depreciation on the revaluation of an asset**

**Scenario:**
An asset has a carrying value of $200,000 and an estimated UEL 20 years at the start of year 1. The asset is revalued to $240,000 at the start of year 1. applicable income tax rate 25%.

**Accounting treatment**

On revaluation the following journal entries are made:

- **Debit** PPE ($240,000 - $200,000) $40,000
- **Credit** Deferred tax liability (25% X $40,000) $10,000
- **Credit** Revaluation reserve $30,000

The $30,000 surplus on revaluation is shown as Other Comprehensive Income in the Statement of Total Comprehensive Income.

The accounting entry for the annual depreciation is:

- **Debit** Depreciation expense ($240,000 X 1/20) $12,000
- **Credit** PPE $12,000

The excess depreciation as a result of the revaluation is $2,000 ($12,000 - $200,000 X 1/20).

The double entry to record the related transfer from the revaluation reserve to retained earnings is:

- **Debit** Revaluation reserve ($2,000 X 75%) $1,500
- **Credit** Retained earnings $1,500

No adjustment to deferred tax is required as a result of the transfer of excess depreciation, because the DT balance is adjusted as a result of the depreciation charge of $12,000 which has reduced the temporary difference.

*(practice T accounts here)*
Depreciation (Cost and Revaluation Models): For all depreciable assets:

The depreciable amount (cost - residual value) should be allocated on a systematic basis over the asset's UEL.

Residual value and UEL of assets should be reviewed each year, if expectations differ from previous estimates, the change is accounted for as a change in estimate (IAS 8).

Depreciation method used should reflect how the asset is consumed by the entity.

The depreciation method should be reviewed at annually, if the pattern of consumption has changed, the depreciation method should be changed as a change in estimate (IAS 8).

Depreciation is charged to SOCI. Depreciation begins when the asset is available for use and continues until the asset is derecognised, even if it is idle.

Depreciation Illustration:
An asset costs £100,000 and has an expected UEL of 10 years. The purchaser intends to use the asset for 6 years at which point the expected residual value will be £40,000.

What is the depreciable amount?

Answer; the depreciable amount is (£100,000 - 40,000) = (60,000/6) years = £10,000 depreciation for each of the 6 years.

When to start depreciation?
Depreciation must be charged from the date the asset is available for use, when it is capable of operating in the manner intended by management. This may be earlier than the date it is actually bought into use, eg, when staff are training to use it. Depreciation continues even if the asset is idle.

Change of method of depreciation:
The depreciation method used should fairly reflect the pattern of usage, the way the asset's economic benefits are consumed, possible methods include: Straight line, reducing balance, machine hours.

Changing from one method to another:
• Is allowed only if the new method will give a fairer presentation of the results and financial position
• Does not constitute a change of accounting policy
• Is a change in accounting estimate

The carrying amount should be written off over the remaining UEL staring in the period the change is made.
Review of Useful Economic Lives (UEL) and Residual Value:
UEL and residual value should be reviewed at end of each reporting period, and revised if expectations are significantly different from previous estimates.

At date of revision (carrying amount - residual value) should be depreciated over the revised remaining UEL

Review of UEL and Residual Value : Illustration : Question:

An asset was purchased for £100,000 (01/01/2005) straight line depreciation of £20,000 charged p/a over 5 years, no residual value. The annual review of asset lives reveals this asset's UEL is 8 years at (01/01/2007). The financial statements for y/e (31/12/2007) are being prepared.

What is the depreciation charge for y/e (31/12/2007)?

Review of UEL and Residual Value : Illustration : Answer:
depréciation charge for current and future years will be:

Carrying Value (CV) as at (31/12/2006) (£100,000 - (2 * 20% * £100,000))  £60,000

Remaining UEL as at (01/01/2007)  8 years

Annual depreciation charge (£60,000 / 8 years)  £7,500
Derecognition : Retirements and Disposals of NCA :

An asset should be removed from the SoFP on disposal or when it is withdrawn from use and no future economic benefits are expected from its disposal.

The gain / loss on disposal is the difference between (proceeds - carrying amount) recognised in the Other Comprehensive Income.

The remainder of the reval res for this asset should be transferred to retained earnings

Disposal of Revalued NCA : Illustration :

Property costing £750,000 was purchased in (01/01/04) and is being depreciated over it's UEL of 10 years. It has no residual value.
As at (31/12/04) property was value at £810,000.
There was no change to it's UEL.
On (31/12/06) property was sold for £900,000.
What is the profit / loss on disposal?

<table>
<thead>
<tr>
<th>£'000</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales proceeds</td>
<td>900</td>
</tr>
<tr>
<td>Valuation at (31/12/04)</td>
<td>810</td>
</tr>
<tr>
<td>Less depn (( 810 / 9 ) * 2)</td>
<td>(180)</td>
</tr>
<tr>
<td>CV</td>
<td>(630)</td>
</tr>
<tr>
<td>Income statement</td>
<td>270</td>
</tr>
</tbody>
</table>
Disclosure: for each class of asset:

- basis for measuring carrying amount
- depreciation method
- UEL or depreciation rates
- gross carrying amount and accumulated depreciation and impairment losses
- reconciliation of the carrying amount at the beginning and the end of the period, showing:
  - additions
  - disposals
  - acquisitions through business combinations
  - revaluation increases or decreases
  - impairment losses
  - reversals of impairment losses
  - depreciation

Also disclose:

- restrictions on title
- expenditures to construct PPE during the period
- contractual commitments to acquire PPE

If PPE is stated at revalued amounts, additional disclosures are required:

- effective date of revaluation
- Details of the independent valuer
- methods and significant assumptions used in estimating FV
- extent to which FV were determined directly by reference to observable prices in an active market or recent market transactions on arm’s length