# CHAPTER 1.2 ACCOUNTING FOR NON-CURRENT ASSETS

## QUESTION 1

Explain what is meant by a non-current asset? [4]

M/J 97/P1/Q4(c)

### SOLUTION

***Mark Scheme***

*Non-current assets are those assets that are purchased for long-term use within the business and not intended to be sold in near future e.g. machinery, premises, furniture, motor vehicles etc. However, purpose of keeping these assets is very important as, e.g. for Northside Motors Ltd motor vehicles held for business use are treated as fixed assets.*

**Suggested Solution**

Non-current assets are those assets that are purchased for long-term use within the business and not intended to be sold in near future e.g. machinery, premises, furniture, motor vehicles etc. However, purpose of keeping these assets is very important as, e.g. for a motor vehicle showroom motor vehicles held for business use are treated as non-current assets.

## QUESTION 2

Explain the term 'depreciation' and give one example. [5]

O/N 09/P22/Q2(b), M/J 16/P22/Q3(a)

### SOLUTION

***Mark Scheme***

*Depreciation is an expense used to spread the **net** cost of a fixed asset over its useful life.*
*If, for example, a motor vehicle costing $10 000 is expected to last for five years after which its scrap value will be $1 000, then its net cost will be $(10 000 – 1 000) = $9 000. Using straight-line depreciation, an annual charge of $9 000/5 - $1 800 would be made in the income statement.*

***[max. 5]***

**Suggested Solution**

Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset. It recognizes the fact that assets with finite lives lose value over time through the passing of time and/or wear and tear from its use.

Depreciation is recorded as an expense in the Income Statement to spread the initial price of the assets over their useful lives to match the revenue the asset is generating.

For example a machine costing $50 000 has an estimated life of 5 years and has a residual/ scrap value of $10 000 then its total depreciable will be ($50 000 – $10 000) = $40 000.

Under straight-line method of depreciation an annual depreciation charge of $8 000 $\left(\frac{\$40\,000}{5\text{ years}}\right)$ would be made in the Income Statement.

## QUESTION 3

State **four** factors which must be taken into account when deciding how much depreciation to charge. [4]

M/J 10/P22/Q2(c)

### SOLUTION

***Mark Scheme***

- *Cost or Market value*
- *Useful life*
- *Residual value at end of useful life*
- *Expected length of ownership*

- *Rate of usage*
- *Method of depreciation*
- *Type of asset*
- *Machine hours*

***Any correct 4 for (4)***

**Suggested Solution**

Whichever method or rate is used to calculate depreciation, we must consider the following:

- the original cost of asset
- the probable/estimated useful economic life of the asset
- the approximate residual value at the end of its life
- estimated amount of expenditure on repairs during the asset's useful life
- possibility of obsolescence etc

## QUESTION 4

Explain the function of depreciation. **[2]**

**M/J 00/P2/Q3(a)**

**OR** Explain why businesses provide for depreciation on their non-current assets. **[6]**

**O/N 11/P23/Q2(c), M/J 14/P23/Q2(a), M/J 15/P23/Q1(c), M/J 16/P31/Q3(c), M/J 17/P22/Q1(c)**

**SOLUTION**

***Mark Scheme***

- *Depreciation is a fall in value of a non-current asset **(1)** due to wear & tear & other factors*
- *Depreciation represents that part of the cost of an asset that is consumed during the accounting period **(1)**.*
- *The provision for depreciation annually is intended to spread the cost over the useful life of the asset.*
- *This follows the matching (accruals) concept **(1)** as matches costs with revenue generated by the assets **(1)***
- *Depreciation is **not** a movement **of cash** from the business.*
- *Depreciating the value of a non-current asset avoids overstating the net assets of the business **(1)***
- *This ensures that the statement of financial position shows a true and fair view **(1)**.*
- *Profit is not overstated. **(1)***

***1 mark per valid point***

**Suggested Solution**

Depreciation represents that part of the cost of an asset that is used up during the accounting period. In other words it is a process by which cost is spread over the useful life of the asset and charged to Income statement.This is charged under matching concept. The value of an asset reduces due to reasons like physical deterioration, obsolescence, inadequacy etc. Depreciating the value of a non-current asset helps the business to include a charge for use of a non-current asset and include them in the statement of financial position at a true and fair view.

## QUESTION 5

State **three** causes (reasons) of depreciation. **[3]**

**M/J 10/P22/Q2(a), M/J 13/P21/Q2(c), M/J 16/P22 Q3(b), M/J 14/P23/Q2(b), O/N 15/P23/Q2(c), M/J 20/P22 Q2(d)**

**SOLUTION**

***Mark Scheme***

- *Wear and tear*
- *Obsolescence*
- *Passage of time*

- *Depletion*
- *Technological innovation*
- *Usage*
- *Economic reasons*

*No marks for methods. Any three correct for (3)* **[3]**

**Suggested Solution**

The following are the main causes of depreciation:

- Wear and tear [physical using up like corrosion, rot, rust and decay];
- Obsolescence [change of fashion or new substitutes or inventions];
- Inadequacy or superfluous [business operation increased hence non-current assets inadequate]

## QUESTION 6

State **three** causes of depreciation and give an example of a non-current asset for which **these** cause might be appropriate. **[3]**

**M/J 10/P22/Q2(b)**

**SOLUTION**

***Mark Scheme***

- ***Wear and tear:*** *Machinery, vehicles*
- ***Obsolescence:*** *Computers, any technological equipment*
- ***Time:*** *Lease*
- ***Depletion:*** *Quarry, oil well* etc.

***No marks for methods. Any three correct for (3) [3]***

**Suggested Solution**

- **Wear and Tear:** Furniture and fixtures may physically deteriorate due to factors like corrosion, rot, rust and decay.
- **Obsolescence:** With the improvement in technology older version of computers or machines may become obsolete.
- **Inadequacy:** An internal telephone exchange with twenty lines may be inadequate when business expands and new lines are needed.

## QUESTION 7

Explain why Land is less likely to have depreciation provided for it than other non-current assets. **[2]**

**M/J 00/P2/Q3(b)**

**SOLUTION**

Normally land has unlimited life so there is nothing within land to depreciate unless it has value due to the existence of natural resources, then it may be subject to depletion (depreciation) when land erodes or minerals extracted from land etc.

## QUESTION 8

Discuss the difference between depreciation & funds set aside for replacement of non-current assets **[3]**

**M/J 00/P2/Q3(c)**

**SOLUTION**

Depreciation is charged to spread the cost of an asset over its useful life. It is a non-cash expense. It is simply an accounting item so does not provide any cash for replacing a non-current assets. When cash is invested in a profitable manner to provide funds for the replacement of non-current assets then it is known as funds for replacement of non-current assets.

## QUESTION 9

The directors are considering the depreciation rates applied to the non-current assets.

**REQUIRED**

Advise the directors whether or not they should decrease the depreciation rates.
Justify your answer. **[4]**

**O/N 18/P23/Q1(e)**

**SOLUTION**

***Mark Scheme***

***Reasons for:***

- *Profit would increase in the short term.*
- *The capital base / asset base of the company would rise in the short term.*

***Reasons against:***

- *The change would not be in accordance with the accounting concept of consistency.*
- *The change would not be prudent.*
- *Assets could be overstated.*
- *Lower depreciation charges would mean higher losses on disposal.*
- *The change would not help profit in the long term.*

***(max 1)** for positive comments, **(max 2)** for negative comments plus **(1)** for decision **[4]***

**Suggested Solution**

**Reasons for:**

- Increase in profit in the short term.
- The net worth of the business would rise due to increase in asset base of the company.

**Reasons against:**

- The change would result in overstatement of assets.
- Lower depreciation charges would mean higher losses on disposal.
- The overall impact of change on profit in the long term would be the same.
- The change would contravene consistency concept.
- The change would go against prudence concept.

## QUESTION 10

Name **three** methods of depreciation. **[3]**

**M/J 00/P2/Q3(d), M/J 14/P21 Q2(b), O/N 20/P22/Q2(a)**

**SOLUTION**

***Mark Scheme***

- *Reducing balance method **(1)***
- *Straight line method **(1)***
- *Revaluation **(1)*** ***or any other valid method [3]***

**Suggested Solution**

- Straight line
- Reducing balance
- Sum of years' digits
- Revaluation
- Units of production

## QUESTION 11

Discuss the suggestion that it should be possible for a business to change the method of depreciation used every year, depending on circumstances. **[3]**

**M/J 00/P2/Q3(d)**

**SOLUTION**

The depreciation methods should be applied consistently from one year to other (consistency concept). Methods of depreciating the assets can only be changed if the new method is expected to give a fairer value for non-current assets as allowed by IAS 16, however the method must not be changed repetitively.

## QUESTION 12

State **an** accounting concept which is applied when depreciation is provided. **[1]**

**M/J 14/P22 Q2[d (i)], M/J 18/P22/Q3(d), O/N 16/P22/Q1(e)**

**OR**

Explain **two** accounting concepts which are being applied when depreciation is provided. **[4]**

**O/N 15/P23/Q2(d), O/N 17/P22/Q3(b), M/J 18/P21 Q2(c)**

**SOLUTION**

***Mark Scheme***

- ***Consistency** (1) using the same depreciation method each year **(1)** to assist comparisons of performance between years. **(1)***
- ***Prudence(1)** reducing the cost of the asset to net book value so not overstating asset worth **(1)** and charging depreciation as an expense to reflect asset use and so not overstating profits **(1)**.*
- ***Accruals / matching (1)** matching wear and tear of the asset via use against the reduction in value **(1)**. Matches the cost of the asset **(1)** with the income generated from its use **(1)**.*

***(max 3 marks for one concept only)***

**Suggested Solution**

- The **matching principle** requires that the actual cost of non-current assets be allocated to the accounting periods in which the company will benefit from their use.
- As most non-current assets lose value over time so **prudence concept** requires that the accounts of a business should show a fair view of the financial position so it is necessary to record this loss in value.
- **Consistency concept** requires that same depreciation method should be used over the useful life of the asset.

## QUESTION 13

SMC is considering changing the depreciation method for equipment to reducing balance method. Explain the possible reasons why the business is considering this change. **[7]**

**M/J 14/P22 Q2[d (ii)]**

**SOLUTION**

***Mark Scheme***

- ***Straight line depreciation** is easy to calculate **(1)** and therefore there is less chance of errors **(1)** whereas reducing balance depreciation is more complex.*
- ***Reducing (diminishing) balance** depreciation has a higher depreciation charge in earlier years **(1)** which more accurately reflects the profit **(1)** – prudence **(1)** and matches costs to revenues **(1)** – matching / accruals **(1)**.*
- ***Straight-line depreciation** is an equal charge each year **(1)**. As equipment gets older maintenance costs increase **(1)** and with reducing balance method depreciation will decrease **(1)** therefore ensuring a more even charge **(1)** over the life of the asset.*

**(Maximum 7 marks) [7]**

**Suggested Solution**

**Straight line method** is relatively easy and simple to use. Under this method depreciation rate and amount remain constant in each year of asset's life as depreciation rate (%) is always applied

on original cost of asset. This method is best rated for those assets, which provide equal benefit to the business for each year of their useful lives. Examples include building and furniture. Moreover in straight line method annual cost of repairs increases as the asset gets older whereas the annual depreciation charge remains constant. Hence, the total of income statement charge on account of depreciation and repairs increases every year which reduces annual profit progressively.

On the other hand, **reducing (diminishing) balance** depreciation is more complex and difficult to use. This method is very useful for calculating depreciation on assets like equipment, which operate faster, produce more, incur low maintenance costs and perform more accurately when they are new. Under this method, the annual cost of repairs increases as the asset gets older whereas the annual depreciation charge decreases each year. Hence, the total income statement charge on account of depreciation and repairs remains more or less the same each year so will not affect annual profit/loss in a significant manner during the asset's life.

## QUESTION 14

Explain the factors that should be considered before deciding which method to use when depreciating a non-current asset. **[4]**

**O/N 19/P32/Q1(c)**

### SOLUTION

***Mark Scheme***

- *Is the asset expected to earn revenue evenly over their useful working life* ***(1)***
- *Is the pattern of revenue from the asset uncertain* ***(1)***
- *Is the asset going to be used more in the early years of its life rather than later* ***(1)***
- *What is the estimated residual value of the asset at the end of its useful life* ***(1)***

***Accept other valid points.***

### Suggested Solution

- If assets are expected to provide equal benefit to the business for each year of their useful lives, then straight line method is more appropriate.
- For assets like equipment, which operate faster, produce more, incur low maintenance costs and perform more accurately when they are new, then the reducing balance method is more suitable.
- If there are a large number of assets and have low per unit cost but significant in total, then the business should use the revaluation method of depreciation

## QUESTION 15

State why the reducing balance method of depreciation is more appropriate for non-current assets like motor vehicles, computers and plant and machinery **[4]**

**M/J 12/P23/Q2(d), O/N 15/P23/Q2(e), M/J 18/P22/Q3(b), O/N 19/P23/Q2[c(i)], O/N 20/P22/Q2(b)**

### SOLUTION

***Mark Scheme***

*Motor vehicles tend to fall in value more in the early years.* ***(1)*** *They lose value the minute they are registered for use. Repair and maintenance costs increase as the motor vehicle gets older* ***(1)****. The straight line method of depreciation depreciates the vehicle at the same amount each year which does not balance up the increasing repair and maintenance costs in later years.* ***(1)*** *However, the reducing balance method depreciates the motor vehicle more in the earlier years and less in later years. The reducing balance method therefore depreciates the asset less in later years which balances with the increasing repair and maintenance costs thus providing a fairer matching of costs with income generated* ***(1)****.*

***1 mark to a maximum of 4 [4]***

**Suggested Solution**
The reducing balance method is suited to non-current assets such as motor vehicles. As vehicles, in the early years, have lower maintenance costs but give more benefits than in later year. So in early years more depreciation is charged due to greater benefits and less is charged in the later years. Moreover increasing costs are offset by decreasing depreciation charge. The constant depreciation charge does not balance up with the rapid loss in asset's value.

## QUESTION 16

Explain why building is usually depreciated using the straight line method while motor vehicles are usually depreciated using the reducing balance method. **[4]**

**M/J 14/P23 Q2(d)**

**SOLUTION**
***Mark Scheme***
*Assets suffer wear and tear, etc. and lose their value at different rates **(1)**. This might depend on the degree of use of the asset. Vehicles tend to lose more value in the early years of use **(1)**; hence the reducing balance method is more appropriate. Buildings tend to lose value **(1)** more consistently over their lifetime; therefore, the straight line method tends to be more appropriate **(1)**.*

**Suggested Solution**
As vehicles perform more accurately when they are new but also tend to lose more value in the early years of use; therefore the reducing balance method is more appropriate.
Buildings, on the other hand, perform and give consistent benefits to the business and therefore tend to lose value more consistently, hence, the straight line method seems more appropriate.

## QUESTION 17

Explain two accounting treatments for loose tools. **[4]**

**M/J 18/P22/Q3(c)**

**OR**
Explain why the revaluation method of depreciation is appropriate for assets such as loose tools. **[2]**

**O/N 19/P23/Q2[c(ii)]**

**SOLUTION**
***Mark Scheme***
- *Its cost may not be material **(1)** and are difficult to keep track of. **(1)** therefore it is written off as an expense **(1)** on purchase **(1)**.*
- *If there are a large number of items **(1)** and costs are significant **(1)** the business should use the revaluation method **(1)** of depreciation*
- *They are easily broken, damaged or lost and have to be regularly replaced (+)*

***.1 mark each to a maximum of 4 [4]***

**Suggested Solution**
As per materiality concept loose tools may be written off as expenses in the income statement if they are not in large number and do not have a material value.
However if they are large in number with a significant total cost then they may be treated as non-current asset in the balance sheet subject to revaluation method of depreciation.
*Loose tools may or may not remain in the business for more than a year. It is cost effective to value annually as opposed to conventional depreciation*

## QUESTION 18

Briefly outline the advantages and disadvantages of each of these three methods of calculating depreciation. **[6]**

**O/N 97/P1/Q5(A)**

**OR**

Explain one advantage and one disadvantage to a business of using the reducing balance method of depreciation. **[4]**

**M/J 20/P22/Q2(a)**

**SOLUTION**

***Mark Scheme***

**Advantages**

Provides a more realistic charge against profits **(1)** as some assets lose more value in their first years **(1)** as the asset reduces in value so the depreciation charge reduces **(1).**

**Disadvantage**

Is more complicated to calculate **(1)** as the charge changes each year because it is based on the decreasing net book value at the beginning of each year **(1)** rather than the more straightforward equal charge per year when using the straight-line method **(1).**

**SUGGESTED SOLUTION**

**Straight line**

**Advantages**

- It is easier to calculate
- he straight-line depreciation method is by far the most common method
- It is more reliable for the assets whose efficiency or productivity remains constant over their lives.
- This depreciation method is acceptable for income tax purposes.
- In this method, assets can be completely written off.

**Disadvantages**

- It is not useful for those assets, which are more efficient and productive in the earlier years of their lives.
- Straight-line depreciation does not account for the loss of efficiency or the increase in repair expenses over the years
- This method does not reflect the difference in usage of a fixed asset from one period to another.

**Reducing balance**

**Advantages**

- It is more useful for assets, which operate faster, perform more accurately, and produce more when they are new.
- This depreciation method is acceptable for income tax purposes.
- It allocates more depreciation in early years and when it is added to low maintenance cost in early years as compared to later years it gives more equitable expenses connected with use of assets.

**Disadvantages**

- It is difficult to compute
- asset value is not fully depreciated to the scrap value
- It requires high rate of depreciation on fixed assets otherwise it will take a long time to write the asset down to its residual value.

## Revaluation Method

### Advantages

- It is mostly used for the calculation of depreciation of trivial, inexpensive and small fixed assets that are normally accounted as a collective unit.
- This method makes the calculations easier, because it becomes complicated to assess depreciation of each of such assets separately.

### Disadvantages

- As every year revaluation is desired it presents various problems.
- Amount of depreciation is always unequal.
- The valuation of asset is very time consuming.

Normally used for calculating depreciation of items such as loose tools and farmers' livestock where it is difficult to estimate with any certainty the rate at which the asset will depreciate.
Under the system each year the asset is valued at the end of the accounting period and the value is compared with that in the beginning of the year. The fall is treated as depreciation for that period.

| Formula | Depreciation | = | Value of asset at the beginning | + | new assets purchased | – | Value of asset at the end |
|---|---|---|---|---|---|---|---|

**Asset Account**

| Year | | $ | Year | | $ |
|---|---|---|---|---|---|
| First date | Balance b/f (Cost at year start) | xxxx | Date of Sale | Asset disposal ( Cost of disposal) | xxxx |
| Date of Pur | Bank/Vendor (asset bought) | xxxx | Last date | Balance c/d (Cost at end) | xxxx |
| | | xxxx | | | xxxx |

**Provision for Depreciation Account**

| Year | | $ | Year | | $ |
|---|---|---|---|---|---|
| Last date | Disposal (Depn on asset sold) | xxxx | 1st date | Balance b/f (Total depn at start) | xxxx |
| Last date | Bal c/d (Total depn at end) | xxxx | Last date | Income statement (Current depn) | xxxx |
| | | xxxx | | | xxxx |

**Asset disposal account**

| Year | | $ | Year | | $ |
|---|---|---|---|---|---|
| Date of sale | Asset a/c (Cost of asset sold) | xxxx | Date of sale | Asset a/c (trade in allowance) | xxxx |
| Date of sale | Income Statement: Profit (*) | xxxx | Date of sale | Prov. for depn (depn on disposal) | xxxx |
| | | | Date of sale | Income Statement: Loss (*) | xxxx |
| | | xxxx | | | xxxx |