# Accounting (Basics) - Lecture 7

CLASSIFICATION OF LONG-TERM ASSETS, WAYS OF THEIR ACQUISITION. BASIC PROCEDURES OF ACCOUNTING OF ASSETS ACQUISITION AND DEPICTION DURING THEIR LIFETIME. METHODS OF LONG-TERM ASSETS DEPRECIATION (ACCOUNTING PERSPECTIVE).

# Content

- Classification of long-term (fixed) assets
- Ways of their acquisition
- Basic procedures of accounting of assets acquisition and depiction during their lifetime
- Methods of long-term (fixed) assets depreciation (accounting perspective).

# Long-term assets

- Long-term assets should be the most profitable assets of the company which are kept for a long time and, therefore, a decision about them is a strategic decision made by the top management or owners of the company.
- They are not consumed at once, but gradually through depreciations.

# Long-term assets

- In some cases they are not consumed at all, and do not lose value but, on the contrary, gain it (e.g. land, collections, cultural monuments).
- Their liquidity is the lowest and, therefore, they are located in the balance sheet at the beginning of assets.

# Long-term assets

- They are classified into three basic parts: Long-term assets
  - I. Long-term intangible assets
  - II. Long-term tangible assets
  - III. Long-term financial assets

# Classification of Long-Term Assets

- The accounting system specifies the following accounting groups for long-term assets:
  - Long-term intangible assets
  - Long-term tangible assets, depreciated
  - Long-term tangible assets, not depreciated
  - Intangible and tangible fixed assets under construction and acquired long-term financial assets
  - Advance payments for long-term assets

# Classification of Long-Term Assets

- The accounting system specifies the following accounting groups for long-term assets:
  - Long-term financial assets
  - Adjustments to long-term intangible assets
  - Adjustments to long-term tangible assets
  - Adjustments to long-term assets

# Long-Term Intangible Assets

- These are not physical and provide particular economically beneficial rights for the company.
- The assessment level from which these rights will be considered long-term intangible assets is stated by the company itself (with the exception of goodwill) taking into account the principles of importance and the contextual and fair reflection of assets in the company’s accounting.

# Long-Term Intangible Assets

- The usability time of these assets is longer than one year i.e. the time during which the assets can be used for the existing or accelerated future activities of the company.
- Long-term intangible assets are reproduced gradually through depreciation.
- The method and time of depreciation are selected by the company in the depreciation plan (with some exceptions in different accounting systems).

# Long-Term Intangible Assets

- The company usually uses the following accounts for keeping records of long-term intangible assets:
  - Research and development
  - Software
  - Valuable rights
  - Goodwill
  - Other long-term intangible assets
  - Intangible fixed assets under construction
  - Paid advances for intangible fixed assets

# Tangible Fixed Assets

- These assets have a physical, tangible form.
- They are items put into a state so that they can be used i.e. completing items and meeting the technical functions and obligations stated by special regulations for use (can be put into operation).
- They can be depreciated or not depreciated.

# Tangible Fixed Assets

- The depreciation period, which depends on the time of use and the depreciation method, is selected by the company in the depreciation plan (with some exceptions in different accounting systems).
- The valuation from which the enterprise considers assets as fixed tangible assets can be chosen by the company (according to concrete accounting rules in sigle countries).

# Tangible Fixed Assets

- The company usually uses the following accounts for keeping records of long-term tangible assets:
  - Land
  - Buildings halls and structures
  - Capital equipment and property units
  - Perennial crops
  - Breeding and draught animals
  - Other tangible fixed assets

# Tangible Fixed Assets

- The company usually uses the following accounts for keeping records of long-term tangible assets:
  - Works of art and collections
  - Technical assessment
  - Tangible fixed assets under construction
  - Advance payments for tangible fixed assets
  - Adjustments to acquired assets

# Long-Term Financial Assets

- The company acquires the following assets to:
  - have influence in another company
  - have higher revenues than from other investment
- In both cases the final objective is to gain an economic benefit by this investment through dividends, a profit share or revenues from the sale of long-term financial assets.

# Long-Term Financial Assets

- The company usually uses the following accounts for keeping records of long-term financial assets:
  - Shares and ownership interest with a controlling influence in enterprises
  - Shares and ownership interest with a substantial influence in enterprises
  - Implemented securities and ownership interests
  - Outstanding securities held to maturity
  - Other loans
  - Other long-term financial assets

# Fixed assets are not:

- Low-value intangible and tangible assets that the company has decided are not fixed assets.
- In this case intangible fixed assets are posted during acquisition into costs (to the debit of the account **“Services”)** and tangible assets are accounted for as with inventories (including handing them over for use to the debit of the cost account **“Consumption of material”).**

# Fixed assets are not:

- The company states what types of these posted assets will be monitored up to cancelling them in the operative record-keeping and showing them in the Notes to the financial statement.
- Short-term financial assets which are recorded in accounting class Financial accounts (see lecture 6)

# Acquisition of Fixed Assets

- The most frequent way of acquiring fixed assets is by purchasing them.
- They can be acquired by the company's activities, the investment of an affiliate or without payment (gift).

# Acquisition of Fixed Assets

- During the acquisition, as in the case of inventories, calculating accounts are used – **Tangible and intangible fixed assets under construction and acquired long-term financial assets**, on which, first of all, all parts of the acquisition price are ascertained and consequently (after meeting all the requirements for the use of assets) they are transferred to the respective assets accounts.

# Fixed Assets Acquired by Purchasing

- They may be purchased through an invoice, in cash or a bank credit.
- They are acquired through calculating account which can be omitted if it is clear there are no outstanding parts of the acquisition price and the asset can be immediately put into use.

# Fixed Assets Acquired by Purchasing

- If the acquisition process is not finished on the day of closing the accounts, these assets remain recorded in calculating account according to the nature of the asset in one of the following accounts:
  - intangible fixed assets under construction,
  - tangible fixed assets under construction,
  - acquisition of long-term financial assets

# Acquisition of Low-Value Assets

- For low-value intangible and tangible assets with a usability time of more than one year, the company can decide whether it will record them as long-term or not.
- If yes, they must be recorded under an internal accounting regulation showing the valuation from which the company considers this asset as long-term.

# Acquisition of Low-Value Assets

- The accounting procedure for the acquisition of low-value assets is the described before.
- After being put into use the assets will be recorded in the respective account as **Land**, etc. or in the account **Capital equipment and property units** and depreciated according to the depreciation plan.

# Acquisition of Low-Value Assets

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# Acquisition of Low-Value Assets

- If the top management of the company decides that low-value assets will not be recorded as long-term, there are two acquisition procedures:
  - the acquisition price of fixed intangible assets is transferred to costs (expenses)
  - for capital equipment and property units with an independent technical specification, the same method is used as for the acquisition of inventories and their consumption

# Acquisition of Long-Term Assets through the Company's Activities

- The company may acquire intangible fixed assets through its own activities (its overheads) as in the case of inventories.
- All costs spent on acquiring these assets are capitalized through costs (expenses) and the asset is recorded in the respective acquisition (calculating) account.
- After meeting the use requirements it is transferred to the respective assets account and is depreciated.

# Cancelling Fixed Assets

- Fixed assets are cancelled mainly because they are depreciated (physical liquidation), sold or donated.
- They can also be stolen (damage) or destroyed.

# Cancelling Fixed Assets

- To cancel depreciated assets, first of all, posting of adjusting entries up to the full amount of the acquisition price (single depreciation of the net book value) must be completed.
- The price of non-depreciated assets and long-term financial assets is posted to the debit of costs (expenses) when they are liquidated.

# Cancelling Fixed Assets

- The costs (expenses) of the physical liquidation are posted to the debit of the account **Other operating costs (expenses)** and any remaining material from the liquidation is taken to the warehouse and is recorded in the account **Other operating revenues.**

# Depreciation of Long-Term Assets

- The company acquires each asset to obtain an economic benefit.
- The asset enters into the economic process in which it is consumed and changed into products that are exchanged for money.
- The degree of the achieved effect depends on the amount of consumed assets of the company and the speed with which they are exchanged (length of the economic useful life of an asset).

# Depreciation of Long-Term Assets

- According to the character of the production, some assets are used by the company over the long term, they are not consumed straight away but gradually and some of them are not consumed at all, but on the other hand they are appreciated in time, such as land, works of art, collections, items of cultural monuments, ownership interests and long-term securities.

# Depreciation of Long-Term Assets

- The gradual decrease in the value of long-term assets as they are used (physical wear or moral ageing) and the transfer of these amounts (depreciation) to the operating costs of the company is called depreciation.

# Depreciation of Long-Term Assets

- There are two kinds of depreciation:
  - accounting (straight-line, regressive, progressive and use)
  - tax (different in different countries according to their tax legislation).

We are going to talk about accounting depreciation only.

# Depreciation of Long-Term Assets

- Long-term tangible and intangible assets are depreciated by the entity with the ownership or management rights to them.
- Exceptionally, long-term assets are depreciated by the lessee in the case of leased movable assets and real estate which are used by the lessee during the entire taxable period or technical appreciation or they were paid by the lessee and the owner increased the input price. There are two kinds of depreciation:

# Accounting Depreciations

- The company depreciates long-term assets indirectly through **accumulated depreciation accounts** based on the **depreciation plan.**
- This plan is created by the company for individual items depending on their expected time of use, calculating methods and the way they are used.

# Accounting Depreciations

- Long-term assets are recorded in the respective account at the purchase (input) price and their overall depreciation resulting from cleared depreciations is monitored in the respective **accumulated depreciation accounts**.
- The **net book value** is ascertained by comparing both accounts, i.e. the part of the input price of long-term assets which will be transferred to the costs (expenses) of the company during the remaining time they are used.

# Accounting Depreciations

- Depreciations are booked up to 100% of the input price.
- Depreciation starts usually in the month after the assets are put into use.
- Tax depreciation can be usually temporarily interrupted, whereas accounting depreciation cannot be interrupted.

# Accounting Depreciations

- Long-term tangible and intangible assets which do not meet the stated limit by the company, i.e. ‘low value’ long-term assets, can be depreciated gradually or consumed once off (as inventory or a service).
- The calculated depreciations are rounded upwards.

# Accounting Depreciations

- If a difference arises in the amount of accounting depreciations (depreciation of long-term intangible assets and tangible assets) and tax depreciations (depreciations mentioned when calculating the income tax base), this business result must be modified when counting income tax base.

# Accounting Depreciations

- Therefore, small and medium-sized firms which are not audited and do not need to know the economic depreciations of long-term assets for the price calculations of their products, are recommended to have the closest unity of tax and accounting depreciations.

# Accounting Depreciations

- Accounting depreciations are divided into time depreciation and performance based depreciation.
- Time depreciation can be stated as **even, accelerated or decelerated** according to the following equation:

# Straight-line accounting depreciation

$$D = P / t$$

- Where
  - D = depreciation
  - P = input price
  - t = number of years of economic useful life

# Straight-line accounting depreciation

- With even depreciation the level of the annual (monthly) depreciation is not changed - $D_1 = D_2$ - it is constant.
- The main advantage of this, the most used depreciation method, is its simplicity.

# Accelerated (regressive) accounting depreciation

$$D = (2 \times P \times (t+1-i)) \ / \ (t \times (t+1))$$

- Where
  - i = a year of depreciation

# Accelerated (regressive) accounting depreciation

- The rule that depreciation in a previous year is higher than in the following year applies to accelerated depreciation - $O_1 > O_2$ .
- The basic advantage of this depreciation method is that it enables the economic resources of the company and the implementation of new, modern technology to be accumulated faster.

# Accelerated (regressive) accounting depreciation

- It protects the company against the moral ageing of long-term assets and decreases the risk of inflation.

# Decelerated (progressive) accounting depreciation

$$D = (2 \times P \times ((t+1) - (t+1-i))) / (t \times (t+1))$$

# Decelerated (progressive) accounting depreciation

- The company can select the progressive depreciation method if it needs to decrease costs (expenses) in the first years and, on the other hand, decrease the business result (profit) later.

# Performance-based depreciation

- This is used for machines or equipment and shows the technical (physical) wear of long-term assets.
- However, the disadvantage is that it does not reflect moral (economic) wear of long-term assets.
- The amount of depreciation depends on the expected total use and its allocation during the time of use.

# Performance-based depreciation - Example

- *Calculate the depreciation on a machine with an acquisition price of CZK 600,000 over an eight-year economic useful life - the company assumes production of 2 million products according to the below sales budget.*

# Performance-based depreciation - Example

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|---|---|---|---|---|---|---|---|---|
| Sales in thousands | 200 | 200 | 200 | 200 | 300 | 400 | 300 | 200 |
| Depreciation CZK thousands | 60 | 60 | 60 | 60 | 90 | 120 | 90 | 60 |

The depreciation rate per output unit is 600,000 / 2,000,000 = 0.3 CZK/item.

# Example

- *The company purchased a personal car in February 2018 for CZK 480,000 which it wants to use for four years. Calculate and book the straight-line accounting depreciation by the end of the accounting period, i.e. by 31.12.2018.*

# Example

- *The depreciation is calculated for the period from starting to use the asset up to the end of the calendar year, i.e. 10/12 of the value of the annual depreciation which for straight-line depreciation is CZK 120 thousand.*

Capital equipment

| | |
|---|---|
| PS 480 | |

Accumulated depreciation

| | |
|---|---|
| | 1) 100 |

Depreciation (expenses)

| | |
|---|---|
| 1) 100 | |