Session 6 (12th/14th November) – *Asset Valuation, Profit Measurement & The Underlying Accounting Concepts*

The figure for profit appearing in the final accounts depends on the amounts at which assets reported in the balance sheet, are valued. Any errors made when valuing assets have a corresponding effect on the level of reported profit and, therefore, reduce its usefulness as a basis for assessing performance.

Stock Valuation Methods

The fundamental rule is that stock should be valued at *"the lower of cost and net realisable value"*. Basically NRV is the *market selling price of stock less any further costs to be incurred by the firm in relation to the asset up to the time of disposal.*

With regards to arriving at a figure of closing stock the following cost basis may be followed:

a. **The marginal cost basis**. Only those costs which can be traced directly to the item manufactured are included in the valuation eg materials costs and the wages paid to those employees directly involved in processing the materials.
b. **The total cost basis**. All manufacturing costs are included, ie the marginal costs plus a fair proportion of incidental manufacturing expenses, called "manufacturing overheads".

A company must be able to cover all it costs if it is to survive and flourish in the long run, and for this reason companies are required to use the total cost basis when valuing stock for inclusion in the accounts published for external use. For internal reporting purposes, however, either total costs or marginal costs can be used and management may well regard the latter as the more relevant basis for short-run business decisions.

When identifying purchases with sales either of the following two methods may be applied: First In First Out (FIFO) or Last In First Out (LIFO). In the latter case the first items purchases are the first items sold. The items in stock are therefore the most recent acquisitions. Hence the stock figure reflects current market prices. IFRS 2 which deals with Inventories, prefers FIFO but provides for LIFO as an alternative method of accounting for stock items.

The Distinction between Capital Expenditure and Revenue Expenditure

All expenditure incurred by a business must be accounted for as either:

1. CAPITAL EXPENDITURE, or
2. REVENUE EXPENDITURE.

The following matrix should help to identify under which category an expenditure would fall:

TYPE OF EXPENDITURE	EFFECT
CAPITAL	Enhances the company's long run ability to earn profits
REVENUE	Maintain's the business ability to operate

Depreciation Methods

From earlier sessions attention was drawn to the fact that depreciation must be charged in the accounts in order to recognise the fact that the business has benefited from using fixed assets which, as a result, have declined in value. The pattern of benefit which arises differs from one type of fixed asset to another. For example, some fixed assets produce a greater benefit in the early years of ownership, when the asset is more efficient, whereas other fixed assets make a fairly steady contribution over their entire useful life. There are a number of different methods of charging depreciation, and management should choose the one, which most closely reflects the pattern of benefits received. The two methods most commonly used are:

1. Straight Line (Equal Instalment) Method

Under this method the difference between original cost and ultimate disposal value is spread evenly over the asset's estimated useful life. The method assumes that each accounting period benefits to an equal extent from using the fixed asset. The annual charge is calculated on the basis of the following formula:

$$\frac{\text{Original Cost} - \text{Estimated Disposal Value}}{\text{Estimated Useful Life}}$$

2. Reducing (Declining) Balance Method

This is the second most popular method. A fixed depreciation rate is applied to the net book value (ie original cost less accumulated depreciation) of the asset brought forward at the beginning of each accounting period. The depreciation rate is pitched at a level which reduces cost to disposal value over the fixed asset's estimated useful life. The appropriate rate may be identified using the following formula:

$$R=(1-n\sqrt{s/c})*100$$

An argument sometimes put forward for using this method is that repair and maintenance costs normally increase as a fixed asset gets older, and the reducing balance basis therefore helps to ensure that the total annual charge (depreciation + maintenance) remains steady over the asset's useful life.

Intangible fixed assets

Business assets may be classified as either tangible or intangible. Tangible assets possess a physical existence; the most common examples are stocks and fixed assets. Intangible assets possess no physical existence but they are valuable because they help the firm to earn a profit. The most common examples of intangible assets are goodwill and research & development.

With respect to **Goodwill** a distinction has to be drawn between purchased and internally generated goodwill. The latter is built ***"up gradually over the years and, when a business person 'sells up', he or she expects the buyer to pay a price which covers the value of this asset"***[8]. Such goodwill cannot be recognised in the financial statements. Either of the following two methods are available to value goodwill:

1. Weighted average profits basis;
2. Super profits basis

On the other hand ***purchased goodwill*** should be recognised in the financial statements and has been defined as ***"any excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired at the date of the exchange transaction"***[9]

IFRS 38 – *Intangible assets* prohibits the recognition of internally generated goodwill as an asset. IFRS 22 – *Business Combinations* requires that purchased goodwill should be recognised and accepts that it may be positive or negative. Positive goodwill must be recognised as an asset and amortised, on a systematic basis, over its useful economic life.

Accounting Concepts

Entity concept - This fixes the boundary for the financial affairs contained in an accounting statement. In its simplest form a limited liability company has a separate legal entity ie there is a distinction between the owners and the company itself.

Money Measurement concept – A business asset is reported in the balance sheet only if its value can be measured, in money terms, with a reasonable degree of precision.

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[8] Introduction to Accounting 3rd Edition by Pru Matiott et al ; p.203

[9] IASB & SIC interpretations – Glossary of Terms, pg G-16

Matching concept – The accountant measures profit for a period of time such as a year, by comparing or "matching" revenue and expenditure identified with that period. The first step is to identify revenues and the second step is to deduct the expenditures incurred in producing the revenues. For example, the matching concept is put into effect by applying the realisation concept and the accruals concept.

Realisation concept – Revenue is earned when a sale takes place and a legally enforceable claim arises against the customer. The effect of this rule is that stock usually remains in the books at cost until the sale takes place, at which stage a profit arises or a loss is incurred.

Accruals concept – Costs are matched against revenues when the benefit of the expenditure is received rather than when the cash payment is made.

Historical cost concept – Assets are initially recorded at the price paid to the supplier. A disadvantage of using the historical cost is that, during a period of rising prices, the reported figures may significantly understate the asset's true value to the business.

Going concern concept – This assumes that the business is a permanent venture and will not be wound up in the foreseeable future.

Consistency concept – The same valuation methods should be used each year when preparing accounting statements. While consistency is a fundamental accounting concept, it does not mean that methods, once adopted, can never be changed, but sound and convincing arguments must be put forward to justify departures from existing practice.

Prudence concept – The prudence concept (sometimes called the concept of conservatism) requires the accountant to make full provision for all expected losses and not to anticipate revenues until they are realised.

Materiality concept – Accounting statements should contain only those financial facts, which are material, or relevant, to the decision being taken by the recipient of the report. It is therefore important for the accountant to the familiar with the user's requirement so that he can decide which information should be included or excluded.