Bloomsbury Professional
Accounting

Excerpt from Small Company Financial Reporting – Chapter 5 – Reporting the Substance of Transactions

DERECOGNISING ASSETS AND LIABILITIES

5.9

It is important that assets and liabilities are recorded in the financial statements when transactions meet the definitions of such assets and liabilities (as per the *Concepts and Pervasive Principles* in FRS 102 (March 2018), Section 2 and FRS 105 (March 2018)) and also that they are derecognised when it is no longer appropriate to recognise such assets and liabilities.

Derecognising an asset

5.10

In the broadest sense of the concept, an entity will derecognise an asset when it is no longer probable that economic benefits will flow to the entity, or it has sold the asset and all the risks and rewards of ownership have been passed to the new owner, or the contractual rights to the cash flows associated with a financial asset have expired or are settled.

Focus

- Where financial assets are concerned, it is important that the derecognition criteria in FRS 102, para 11.33 (FRS 105, para 9.21) are complied with.

Assets can involve (among others):

- non-current (fixed) intangible and tangible assets;
- financial assets, such as investments;
- investment property;
- inventory (stock) and work in progress; and
- amounts owed to the entity (trade and other debtors).

In some cases it is fairly clear when the asset should be removed from an entity's balance sheet. In other cases (as with financial assets), more analysis work will be needed to ensure appropriate derecognition takes place at the correct time.

Non-current (fixed) intangible and tangible assets

5.11

A reporting entity will remove a non-current (fixed) intangible or tangible asset from its balance sheet when it is no longer probable that economic benefits will flow to the entity from that fixed asset. Examples of circumstances where this could be the case are:

- the asset is no longer in working order and has been scrapped;
- the asset has been sold to a third party; and
- the asset has been exchanged for another asset in a transaction that possesses commercial substance.

When a fixed asset is removed from the books of a reporting entity, the net book value is compared to any sales proceeds received and the resulting gain or loss will be reported as a profit or loss on disposal of the fixed asset(s) in the entity's profit and loss account. As discussed in **Chapter 4**, it is important to make a distinction between gains and losses on disposal of such assets and revenue and expenses from the ordinary course of business. Ordinarily, a reporting entity would report any profit or loss on disposal of a fixed asset in profit or loss as a profit or loss on disposal as opposed to revenue or expense.

Example 5.1 – Disposal of a machine

Pilau Co Ltd has disposed of a machine in its manufacturing division during the year to 31 December 2018. On 31 December 2017 the machine had a carrying value in the financial statements of £36,000, made up of £60,000 cost £24,000 accumulated depreciation. The company's declared accounting policy in respect of depreciation is to charge a full year's depreciation in the year a fixed asset is acquired, and charge no depreciation in the year of disposal. The machine was sold on 31 March 2018 for £40,000 to an unconnected third party.

As the company's depreciation policy is to charge a full year's depreciation charge in the year of acquisition and no depreciation in the year of disposal, the carrying value of £36,000 will be compared to the sales proceeds (£40,000) and this will result in a profit on disposal of the machine of £4,000. The journals to remove the machine from the books of Pilau Co Ltd will be as follows:

<u>To remove the net book value at the date of disposal</u>

Dr Plant and machinery disposal account (profit and loss) £60,000

Cr Plant and machinery disposal cost (balance sheet) (£60,000)

Being removal of original cost

Dr Plant and machinery eliminated depreciation (balance sheet) £24,000

Cr Plant and machinery disposal account (profit and loss) (£24,000)

Being removal of accumulated depreciation on the machine

Dr Bank £40,000

Cr Plant and machinery disposal account (profit and loss)	(£40,000)

Being sales proceeds on machine disposal

The disposal account will show a £4,000 credit balance on the trial balance after these entries representing the cost credited (£60,000), the eliminated depreciation charge debited (£24,000) and the sales proceeds credited (£40,000). This profit may be reported in cost of sales as disposal of manufacturing plant, or the company may choose to show it within administrative expenses. In any case the profit on disposal (and the disposal proceeds) must not be categorised as turnover.

Financial assets

5.12

Financial assets can encompass a number of things including long-term investments in equity shares and long-term loans. Extensive guidance is included in FRS 102 (March 2018), Section 11 *Basic Financial Instruments* (and FRS 105 (March 2018), Section 9 *Financial Instruments*) which also provides some examples of financial assets.

Generally, a reporting entity can only derecognise a financial asset when the following criteria are met:

- the contractual rights to the cash flows from the financial asset expire or are settled; or
- the entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset; or
- the entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party and the other party has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. In this case, the entity shall:
  - derecognise the asset; and
  - recognise separately any rights and obligations retained or created in the transfer.

Example 5.2 – Sales ledger sold to a finance house

Bury Enterprises Ltd (Bury) has recently seen a decline in activity during the last couple of years which has been largely due to a downturn in the market. Despite the company's sales volumes and related profits experiencing a decline, the company's sales ledger has increased in size as its customers are demanding longer terms of credit as they, themselves, are waiting on payment from their customers.

On 2 January 2019 Bury completed the sale of its sales ledger to the bank. The proceeds received from the bank were less than the fair value of the debtors, but gave Bury access to immediate working capital to help it continue in the difficult period. Whilst Bury has sold the ledger onto the bank it still continues to collect monies in from the customers and send out monthly statements. To recompense Bury for this service, the bank pays them a monthly service charge which is at market rate. Bury must remit all monies received from customers to the bank immediately and there is no recourse on Bury if any of the customers are late in paying their debts or if they are unable to pay due to cash flow difficulties or liquidation.

In this example Bury has transferred all the risks and rewards associated with the sales ledger to the bank. The terms of the agreement make no recourse to Bury in the event a customer is slow in making paying or fails to make payment and the debt is subsequently written off.

As the risks and rewards have been transferred, Bury must remove all the debtors from its balance sheet and recognise a loss on derecognition of these balances which is calculated as the fair value of the proceeds received by the bank less the carrying value of the debtors at the time of the sale (2 January 2019).

The proceeds received from the bank are not recognised as a liability in the balance sheet. Bury will only recognise a liability to the extent that it has received monies in from the customers but which have not yet been remitted to the bank.

In the above example, the risks and rewards had been transferred from Bury to the bank and hence the financial asset (the debtors ledger) qualified for derecognition. In some cases it may not be as clear cut that the risks and rewards of ownership have been transferred.

Example 5.3 – Sales ledger sold to a finance house

The facts are the same as in the example above. However, this time Bury has agreed to buy back any customer debts which are in arrears for more than 90 days.

In this example, Bury has retained a significant risk which is the risk that customers may be slow in making payment or may not pay at all.

Bury will not derecognise the trade debtors in this example and they will continue to be reported on the balance sheet. The proceeds from the bank will be recognised as a loan which is secured by the debtors. Debtors will continue to be recognised as assets until they are collected or they have been written off due to uncollectibility.

Investment property

5.13

Investment property is dealt with in FRS 102 (March 2018), Section 16 *Investment Property* and in FRS 105 (March 2018), Section 12 *Property, Plant and Equipment and Investment Property*. An entity must derecognise investment property when the property itself has been sold or transferred (with the risks and rewards of ownership also being transferred). In addition, investment property may need to be derecognised as such and **reclassified** as owner-occupied property when the investment property no longer meets the definition of an investment property (eg the company now uses the property to house some, or all, of its operations). On the date that the investment property is reclassified to property, plant and equipment, the carrying value is treated as the property's deemed cost going forward.

Focus

- When investment property is reclassified as property, plant and equipment, it is not a change in accounting policy, but instead is a change in circumstances. Paragraph 16.10(e)(iii) requires disclosure of transfers to property, plant and equipment. For small companies reporting under Section 1A, this is not a mandatory disclosure, but the directors would need to consider making this disclosure in order that the financial statements give a true and fair view (**Chapter**

6 examines the application of disclosure requirements to achieve a true and fair view in more detail).

Inventory (stock) and work in progress

5.14

Essentially this links into the revenue recognition section (see next section). The risks and rewards concept which was illustrated above in the sales ledger examples also applies to items of inventory (hereon in referred to as 'stock'). In the order of current assets in the balance sheet, stock is the least liquid asset because the theory is that the stock will be sold, it will then turn into a debtor (assuming the sale is on credit) which will then eventually be paid and turn into cash in the bank.

Assets such as stock are derecognised when the risks and rewards of ownership of the stock have passed to the buying customer. This is also covered by the revenue recognition section in FRS 102 (March 2018), Section 23 *Revenue* (FRS 105 (March 2018), Section 18 *Revenue*) which outlines the procedures for recognising revenue within the financial statements.

The carrying value of stock can also be reduced (or partly reduced) through an allowance account (ie a provision). FRS 102 (March 2018), Section 13 *Inventories* (FRS 105 (March 2018), Section 10 *Inventories*) requires stock to be valued at the lower of cost and estimated selling price less costs to complete and sell (the term in UK GAAP for 'net realisable value').

Where the estimated selling price less costs to complete and sell is lower than cost, a write-down will be required. In some cases the write-down of the stock will be its entire cost because the estimated selling price less costs to complete and sell will be nil. However, this is only done where there is evidence that such stock has an estimated selling price less costs to complete and sell of nil.

Example 5.4 – Stock write-down

Cory Computers Ltd manufactures laptop computers and reports under FRS 102. During the year to 31 December 2018, the company manufactured a batch of computers which cost £8,000 to make, but on final testing before being available for sale it was discovered that the computers did not work. Upon investigation it was found that this batch of computer equipment was faulty due to a faulty mechanism within the machines themselves and this particular type of computer has been withdrawn from the market by the directors and further stock will not be sold. The computer equipment was scrapped on 16 January 2019 and did not have any scrap value.

In this case the assets costing £8,000 will be derecognised from the inventory and recognised at estimated selling price less costs to complete and sell of £nil to comply with the principles in Section 13.

Amounts owed to the entity

5.15

Amounts owed to the entity can be in respect of trade debtors or other debtors, such as loans to employees or recoverable taxes.

Debtors (whether trade or other) essentially constitute a financial instrument and the same provisions for derecognising a financial asset will equally apply.

Amounts owed to an entity in respect of debtors are derecognised when the contractual rights to the cash flows from the financial asset expire or are settled. It follows, therefore, that a trade debtor is derecognised when the customer pays or when the amounts are written off.

Derecognising a liability

5.16

The general rule in FRS 102 (March 2018) and FRS 105 (March 2018) is that a reporting entity will derecognise a financial liability (or part thereof) only when it is extinguished. The term 'extinguished' means when the obligation giving rise to the liability is discharged, cancelled or expires.

Liabilities generally include (among other things):

- amounts owed to suppliers and other creditors;
- amounts owed in respect of loans and other financing agreements.

Amounts owed to suppliers and other creditors

5.17

In practice, a financial liability in respect of suppliers and other creditors is derecognised when the entity pays that (other) creditor. This usually happens as a matter of course, but there may be other situations which give rise to a financial liability being derecognised, such as where the obligation is cancelled or expires.

Example 5.5 – Entity wins a legal dispute

In the year to 31 December 2018, Heyes Haulage Co Ltd (Heyes) was taken to court by a member of the public claiming personal injury and loss of earnings in respect of one of Heyes' drivers who was alleged to have caused damage to the person's motor vehicle on a busy motorway. The vehicle that was damaged was written off by the insurers and the injured person is also claiming damages for injuries sustained by Heyes' lorry. The driver of the lorry has always maintained that the damage and the injuries were caused by the driver himself.

At 31 December 2018 Heyes' lawyers advised that it was probable that the company would be found guilty and hence the accountant made a provision for costs and damages in the sum of £35,000. However, CCTV footage has emerged showing that the claimant was driving dangerously and erratically and it was subsequently found that the claimant caused the crash in which his vehicle was written off. The judge found in favour of Heyes.

The financial liability that has been recognised in the accounts (the provision for costs and damages) should be removed from the books because it has now been cancelled.

Amounts owed in respect of loan and other financing agreements

5.18

Generally, liabilities in respect of loans and other financing agreements are derecognised from the financial statements when they are settled. This can occur over time (eg when the company is making instalments) or it can happen at a specific point in time (eg a creditor may agree to write off any remaining loan balance).

Example 5.6 – Company completes a company voluntary arrangement

Five years ago, a company entered into a voluntary arrangement with its creditors because it had run into cash flow difficulties due to a downturn in the market. It had lost a number of contracts and the majority of creditors agreed to the arrangement.

The company has now successfully completed the arrangement and has paid all the creditors in accordance with the formal Company Voluntary Arrangement (CVA). The accountant is unsure what accounting entries to make in respect of the balance which has been agreed to be waived by the creditors.

Amounts should only be written off in a CVA when the CVA itself has been successfully completed (not before). Therefore in a successful CVA, the company's obligations in relation to the remaining balance which has been waived by the creditors has been cancelled and hence the entries would be:

Dr Creditors

Cr Profit and loss (usually as an exceptional item)

Other loans and financing arrangements can be discharged by the holder of the financial instrument if provisions exist in the loan agreements, such as where 'convertible debt' is concerned.

Example 5.7 – Convertible debt

On 1 January 2014 a company borrowed £20,000 from a third party. The terms of the loan agreement said that a market rate of interest is payable annually and that on maturity, the loan note holder has the option to convert the remaining principal amount into shares, rather than demand repayment, at the discretion of the loan note holder. The loan matures on 31 December 2018.

On 31 December 2018, the company's cash balance was fairly restricted due to money being tied up in stock and debtors. In addition, the company was also undergoing an asset replacement cycle by replacing all plant used in the manufacturing process so as to increase market share.

The loan note holder has exercised the option to convert the principal amount of £20,000 into shares of the company as she has recognised that the company's long-term plans are looking very healthy.

On 31 December 2018, the financial liability (the loan note) will be derecognised and will be reallocated to equity to recognise the additional shares which are now owned by the loan note holder. This is an example of a financial liability being discharged in forms other than cash.

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