FINANCIAL REPORTING | BASIC

Video Transcription: The Asset Life Cycle

Hi, my name is Nabeelah and in this video, I am going to be discussing the asset life cycle.

Some concepts, principles or topics are relevant to you regardless of your year of study in financial reporting. Today's topic is one of these. Regardless of whether you are in first year undergraduate studying or whether you are preparing for qualifying exams or if you are preparing financial statements, the financial reporting process is relevant to you. We are going to look at an overview of the financial reporting process. In other words, this is the time from when an element is first recognised in the financial statements to the time when it is removed from the financial statements. I would like to think of the financial reporting process as a cycle.

Kind of like this: we will populate this diagram as we go through the video. Let's take a closer look at the financial reporting process by looking at assets. The first thing to ask or the starting point is, does the entity have an asset? In other words, we are going to need to identify whether there is an asset in the given scenario. In order to do this, it is very useful to use the asset definition that is contained in the Conceptual Framework of Financial Reporting.

In other words, does the entity have a present economic resource controlled by the entity as a result of past events? Let's use two examples to investigate this thought process further. The first one being a motor vehicle that we acquire and the second one being data from research into the development of a brand new motor vehicle. In the first example, the resource is the right to thea motor vehicle, which we have acquired either through purchase by cash or on credit. Or more simply put, the asset is the motor vehicle. The vehicle has the potential to produce economic benefits for the entity as it is used by the entity in business operations. In the second example, we have got some research, or we have got data from research, which is likely to develop a new asset, a new motor vehicle. The entity has a right to this data because the entity created this know-how. The data is also controlled by the entity, because only the entity can use it; no one else has access to it. Furthermore, the data has the potential to produce economic benefits for the entity; either by allowing others access to this data for a fee, or manufacturing and selling the new motor vehicle that the research data relates to. Both examples lead to assets as defined for the entity.

Once the entity has identified that it may have an asset, the next question to ask yourself is, can it recognise this asset? We look at the asset as defined and we ask ourselves, "Are the recognition criteria for this asset met?" In other words, does recognising this asset provide users with information that is useful i.e. relevant information that can be faithfully represented? Relevant information is information that has low existence uncertainty (i.e. you can confidently say the asset exists), and where the probability of an inflow of economic benefits is NOT low (i.e. there's a good chance the asset will in some way or other, result in economic benefits for the entity). Faithful representation is achieved when measurement uncertainty is low i.e. you either have or can reasonably estimate an amount for this asset. If the asset meets the definition of an asset as defined and the recognition criteria then we can recognise the asset.

So let's go back to our example again. Our first example was a motor vehicle that we purchased. Because we purchased it we are likely to be able to measure the value reliably;, we know what we have paid for it. There is no measurement uncertainty, and therefore the asset can be faithfully represented. Furthermore, recognizing the asset would provide relevant information, as there is no existence uncertainty (the asset is clearly visible!), and the probability of an inflow of economic benefits is not low: there's a good chance that the acquired motor vehicle will be useful and support the businesses objectives. Consequently, recognizing the motor vehicle asset would provide users with useful information.

The data from the research however, is a bit more problematic. We may be able to measure the costs incurred during the research phase, in which case, measurement uncertainty is low, and the asset could therefore be faithfully represented. We may even be able to show that the research data exists and therefore that existence uncertainty is low too. However, the entity is still only in the research phase: the entity is not yet sure that this data is really going to result in a viable new car design; the entity is still just investigating this potential. The probability of an inflow of economic benefits may therefore be too low at this stage of the process, meaning that the information is not yet relevant, and should not be recognised.

So in example one, the entity will have an asset, a motor vehicle. However, in example two because the recognition criteria are not met, it is unlikely that we recognise an asset for the entity.

The first two steps allow us to determine whether the entity has an asset as defined and whether that asset can be recognised on the annual financial statement of the entity.

But, at what amount? The entity needs to determine at what amount to recognise an asset initially in the Statement of Financial Position. In order to do this we need to consider the concept of measurement. But what is measurement? Measurement is the process where we allocate a rand or a monetary amount to the asset to be recognised on our balance sheet. In order to measure the asset it would be pretty useful to know what type of asset we are dealing with. There are many different types of assets. We have got PPE, we have got inventory, we have got an investment property. These are just to name a few. And each of these assets is governed by a separate IFRS.

Knowing what type of asset we have will be very useful in determining the IFRS to apply and to continue in our financial reporting process. In order to determine what type of asset we have, we need to think about the reason why the entity holds the asset. Why did it purchase it in the first place? In other words, how is this asset going to give rise to future economic benefit to our entity? And do not forget that each asset must ultimately lead to future economic benefit for the entity. Determining how this future economic benefit is going to flow to the entity is going to help us to determine what type of asset we have.

So let's look back at our example again, take, for instance, a motor vehicle. Now let us assume that the entity's business is to buy and sell motor vehicles. So in the ordinary course of operations an entity will buy an asset, being a motor vehicle, and resell it. Based on this assumption it is likely that the asset would be inventory for the entity. However, contrast this to another situation – potentially, the same entity has another motor vehicle. However, it holds this motor vehicle to be used as a delivery vehicle. The manner in which the entity intends to use this vehicle means that it is likely to be PPE because this vehicle is going to be used within the normal business operations of the entity.

As I mentioned earlier, distinguishing between the different types of assets you have will allow you to determine which IFRS to apply when accounting for a specific asset. The IFRS will contain the specific requirements relating to the measurement, derecognition, and presentation and disclosure of the asset in question. And we will deal with these a bit more, later. But at this point I would like to remind you as to how important it is to correctly classify your assets.

Many assets will initially be measured at cost. Now, what the cost is will determine what type of asset you have because different assets have different specific requirements for what you can include as cost.

After initial recognition, there are different measurement bases that could be applied to measure different assets. Now, this is the phase we would probably call subsequent measurement of an asset.

There are two broad categories of measurement models: historical cost---based measures and fair value or current cost---based measures. Now, PPE needs to be measured subsequent to initial recognition using either the cost model, which is basically the historical cost of the asset adjusted for depreciation and impairment, or on the revaluation model where the carrying amount of the asset is based on the current price or fair value. But do not forget that as part of subsequent measurement we would need to consider whether assets are impaired. Impairment inputs differ depending on what type of assets you have. Again, type of asset is vital. For instance, inventory must be measured at the lower cost and net realisable value. Net realisable value represents future economic benefits from the sale of the asset.

Contrast this to “product, plant and equipment” (PPE), which can never be measured at an amount above its recoverable amount. And for PPE, the recoverable amount is the higher of its value in use, which is the future economic benefits associated with using the item of PPE and its fair value less costs to sell. In other words, what future economic benefits would we attain should we choose to sell the item of PPE? Now, notice the impairment test of the impairment thought process is different for inventory and PPE but this makes sense given the different intentions relating to the assets. Inventory – sale, PPE – use but potentially we could sell it at some point.

We must not forget the concept of derecognition. Now, derecogntion is when we effectively remove the asset from our Statement of Financial Position. Now, this is generally done when there are no future economic benefits left associated with the asset to the entity. So looking at inventory, this will likely be when the inventory is sold or when it is obsolete. And PPEs derecognize for similar reasons: through sale or through consumption. But do not forget that with consumption comes the need to recognise the expense depreciation.

Finally, one must consider how to present and disclose the asset that we recognised in our financial statement. In order to do this, we should probably consult the guidance of IRS1, in other words, presentation of financial statements or the specific IFRS that relates to the assets in question. So for inventory we look at the requirements of IRS2 – Inventories. For PPE we look at IRS16 – Property, Plant and Equipment.

And once again, do not forget that the correct classification of the asset is going to guide you as to which IFRS to use to determine how to present and disclose the asset.

Today, we have applied the financial reporting process to the assets, inventory and PPE. And I would recommend that you try to apply the financial reporting process to other assets you have encountered in your studies.

In addition to this, the financial reporting process, or in this case, the asset life cycle is vital to you when answering a discussion question. When you are answering a discussion question there is generally one area of the financial reporting process that is quite contentious. Using the financial reporting process you will be able to identify this area of contention and focus on that point in your discussion---question answer.

And do not forget that a question asking you to discuss the impact of an item on the annual financial statement will require you to discuss each component of our financial reporting process to provide a well---rounded answer: the financial reporting process, the conceptual framework, journal entries and the accounting equation are all vital tools at your disposal when you are faced with any financial reporting problem.

Something else you guys can do, is to take the financial reporting process and try to apply it to liabilities. See whether you can come up with the same ideas that we have today when dealing with liabilities. If you can do that you are well set to cope with any financial reporting problem.

Thank you for watching.