

What Is Accounting for Fixed Assets?

INTRODUCTION

Most accounting professionals believe that all there is to be learned about asset accounting occurred in the introductory course on principles of accounting. Therefore, although this subject can become quite complex, it has not been explored in the accounting literature.

In 1984 when the Federal Communications Commission (FCC) called for the rewriting of the uniform system of accounts for telephone companies, public utilities had not been following generally accepted accounting principles (GAAP) as outlined by the Financial Accounting Standards Board (FASB) and its predecessors, but instead used procedures that had been outlined in 1934 by the FCC. The team responsible for making recommendations on the rewriting of the system of accounts established a basic policy that what was to be recommended would comply with current GAAP.

The subcommittee responsible for reviewing and recommending procedures for property, plant, and equipment was frustrated by the lack of definitive information on accounting for assets. The primary sources are very limited. The Accounting Principles Board (APB) and the later FASB have been nearly silent on the subject beyond defining depreciation and historical costs.

Accounting Research Bulletin (ARB) 43 was issued in 1953 to summarize all previous GAAP. It requires that depreciation be calculated

and disclosed. Most of the additional discussion on tangible assets involved explaining why depreciation is appropriately calculated using historical costs. It is true that management must take into consideration the probability that plant and machinery will have to be replaced at cost much greater than those of the facilities now in use; however, depreciation must not be calculated on the basis of this expected inflation.

ARB 43 in paragraph C5 goes on to state:

The cost of a reproductive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.

After formation of the Accounting Principles Board, *APB 6* was issued in 1964 continuing the authority outlined in *ARB 43*. The Board continued to support the use of historical cost as opposed to inflation accounting:

The Board is of the opinion that property, plant, and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity.

APB 12, issued in 1967, requires the disclosure of depreciable assets and depreciation. In addition to total depreciation expense and the major classes of depreciable assets, it also requires disclosure of:

- Depreciation expense for the period.
- Balances of major classes of depreciable assets by nature of function, at the balance sheet date.
- Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date.

- A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

CONSUMPTION OF BENEFITS

In 1984, the FASB issued *Concept Statement 5*, which included additional discussion of assets. However, it was also limited in scope, as one would expect in a concept statement.

The discussion emphasized the recognition assumption of assets, clearly indicating that assets are consumed by their use and the cost should be recognized in the accounting periods of their life.

Consumption of economic benefits during a period may be recognized either directly or by relating it to revenues recognized during the period.

Some expenses such as depreciation and insurance are allocated by systematic and rational procedures to the period during which the related assets are expected to provide benefits.

“Any expense or loss (in future benefits) is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated.”

Since its creation, the FASB has entertained considerable discussion about assets, but the only statements issued cover specific assets:

- Expensing versus capitalizing research and development
- The accounting for software
- Depreciation in not-for-profit organization financial statements
- Impairment of Assets
- Involuntary Conversions

FASB Concept Statement 6, Elements of Financial Statements, has more material than any other on the accounting for long-term tangible assets. However, it addresses itself primarily to the definition, the purpose of accrual accounting, and the characteristics of an asset.

In 1985, *Concept Statement 6* added a definition of assets:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

CHARACTERISTICS OF ASSETS

Concept Statement 6 continues, enumerating the three essential characteristics of an asset:

- It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to combine directly or indirectly to future net cash in flows.
- A particular entity can obtain the benefit and control others' access to it.
- The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

This is the first discussion in promulgated accounting rules discussing the definition and characteristics of an asset. The major thrust is that probable future benefit is the definition of an asset. To reflect it on the balance sheet, the entity must be able to obtain benefit from the asset and control others' access to the asset. This statement also reviews the concept of future economic benefit and service potential as it relates to not-for-profit organizations. It states:

In a not-for-profit organization, the service potential or future economic benefit is used to provide desired or needed goods or services to beneficiaries or other constituents, which may or may not directly result in net cash inflows to the organizations. Some not-for-profit organizations rely significantly on contributions or donations of cash to supplement selling prices. . . .

This discussion introduces the argument that depreciation of tangible assets is an appropriate expense of not-for-profit organizations.

In a discussion of accrual accounting, *Concept Statement 6* discusses assets under a heading "Recognition, Matching, and Allocation." In paragraph 145, it states:

Accrual accounting uses accrual, deferral, and allocation procedures whose goal is to relate revenues, expenses, gains, and losses to periods to reflect an entity's performance during a period instead of merely listing its cash receipts and outlays . . . the goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and

other events and circumstances, to the extent that those financial effects are recognizable and measurable.

There is a discussion of costs and revenues to determine profits for periods. Depreciation and assets are excluded from the matching concept. Paragraph 149 of *Concept Statement 6* explains:

However, many assets yield their benefit to an entity over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their use are normally allocated to the periods of the estimated useful lives (the periods over which they are expected to provide benefits) by a rational allocation procedure, for example, by recognizing depreciation or other amortization. Although the purpose of expense allocation is the same as that of other expense recognition—to reflect the using up of assets as a result of transactions or other events or circumstances affecting an entity—allocation is applied if causal relations are generally, but not specifically, identified. For example, wear and tear from use is known to be a major cause of the expense called depreciation, but the amount of depreciation caused by wear and tear in a period normally cannot be measured.

This discussion appears to make the distinction between the matching principle for revenues and expenses and the allocation of the cost of using up future benefits. Although this distinction is subtle, it is the point of basic disagreement between those who argue for inflation accounting and the depreciating of assets based on current market value and those who argue for depreciating using a lesser historical cost.

Appendix B of *Concept Statement 6* further discusses characteristics of assets, defining assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”

Most of this discussion relates to intangible or nonphysical assets. The FASB, in issuing its *Statement 2, Accounting for Research and Development Costs*, also gives us some information on what makes up tangible physical assets. In their concern for the appropriate accounting for research and development costs, they conclude that all should be charged to expense accounts. However, they do give us their thoughts

about which tangible assets should and should not be included in research and development costs.

A prime consideration is that materials, equipment, and facilities that have an alternative future use (in research and development projects or otherwise) shall be capitalized as tangible assets when acquired or constructed. However, the costs of such materials, equipment, or facilities that are acquired or constructed for a particular research and development project and have no alternative future uses and therefore no separate economic values are research and development costs at the time the costs are incurred. All research and development costs encompassed by the statement are charged to expense when incurred. This reflects the concept that research and development costs will be used up during the span of the research project. Tangible assets that have a life beyond the current project, however, should be capitalized and depreciated over their useful lives.

The preceding paragraphs summarize the present state of GAAP relating to property, plant, and equipment.

Many subjects in accounting have not been covered at length within the promulgated statements. Most with the significance of long-term tangible assets have been covered in more detail in secondary accounting material, but few secondary publications provide any in-depth discussion on fixed assets.

Research bulletins and disclosure drafts having to do with inflation accounting have not been allowed to creep into generally accepted accounting principles.

Therefore, in determining the details of an accounting system for property, plant, and equipment with the FCC study in 1984 and 1985, the committee felt it necessary to use the secondary documents on assets. The documents were used to establish current practice and to form a model that telecommunications companies should use instead of the 1934 FCC regulations. The only additional definitive document discussing accounting for property, plant, and equipment was issued by the Institute of Management Accountants (IMA, formerly the National Association of Accountants) as *Statement on Management Accounting (SMA) 4*. SMA 4 was issued in October 1972 with the title, *Fixed Asset Accounting: The Capitalization of Cost*. Several concepts outlined in the twenty-four-page statement include the following:

- Costs through preparation for use
- Extraordinary repairs
- Base unit

Extended life or increased capacity
Written policies
Capitalization policy
Life greater than one year
Self-constructed assets that include direct overhead
No initial development cost
Depreciation

The *SMA 4* discusses a number of concepts which were then, and still are, common practice.

All Costs to Prepare Item for Use

All costs in addition to the invoice price to make an item of property, plant, and equipment ready for use should be capitalized in its historical cost.

Extraordinary Repairs

Normal repairs are charged to expense when incurred; however, extraordinary repairs that extend the life, increase the capability, or increase efficiency of the item should be capitalized during its life, the historical cost increased, and depreciation recalculated from that date forward.

Base Unit

The base unit concept is not dealt with in any other document. It outlines the concept that property units should have a policy determination as to what constitutes the property record entity that is capitalized. The base unit might be a complete machine or the individual components of that machine. This concept is important when establishing a usable property record system for a particular company. For example, entities that use light trucks as maintenance vehicles may wear out a number of trucks during the lives of hydraulic lifts, welding equipment, and utility beds.

Written Policies

It is important for each company to have an asset manual with written policies. Determinations of appropriate base units and other policies unique to a company must be described and documented. Without written policies, asset accounting will not be consistent over a period of time.

Capitalization Policy

A minimum level of capitalization should be identified. Accounting records that cost more than the items are worth are not cost effective.

Life Greater than One Year

Policy should emphasize that items with a life restricted to one accounting period should be expensed no matter what their cost.

Self-Constructed Assets

All costs of preparing assets for use should be capitalized; however, only directly attributable or traceable overhead costs should be included. General and administrative overhead costs should not be capitalized. If a company is not in the business of constructing assets, overhead costs are not likely to be increased by an individual construction project. Therefore, if those costs were capitalized, expenses in the accounting period that the asset was being constructed would be improperly reduced. Additionally, the initial development cost of making a decision on which project to construct should not be included in capitalizable costs. Subsequent costs for a specific project, once the decision has been made, are capitalized.

Depreciation

The idea of the relative permanence of assets that are “fixed” is questioned by *SMA 4*. The statement notes that periods of nonuse should be excluded from the depreciation schedule: “Until these assets can be said to have completely satisfied the purpose for which they are intended—normal or acceptable production capability—they are, for the time being, suspended accounting-wise in a sort of hiatus, not producing income, hence not triggering depreciation against which it is to be set.”

SMA 4 was replaced in 1989 and 1990 by *Statements 4J, Accounting for Property, Plant, and Equipment*, and *4L, Control of Property, Plant, and Equipment*. These two documents were prepared from a research project published by the IMA Research Committee, reporting control and analysis of property, plant, and equipment.

In other documents the discussion of accounting for fixed or physical assets is limited to a chapter, or a few paragraphs in accounting textbooks. No lengthy document has been published that brings all the concepts of accounting for property, plant, and equipment together.

There are many articles on fixed assets in accounting magazines such as *Strategic Finance*, published by the Institute of Management Accountants (IMA) and the *Journal of Accountancy*, published by the American Institute of Certified Public Accountants (AICPA). Most of these articles discuss theoretical issues of inflation accounting and depreciation.

There are a number of accounting courses offered by such organizations as the IMA, AICPA, and the American Management Association, as well as by a number of accounting and appraisal firms. However, these courses are mostly directed toward the tax requirements of accounting for depreciation. Similarly, there are numerous off-the-shelf personal computer programs aimed at fixed asset accounting. Again, the primary purpose is to fulfill tax requirements and generate depreciation entries. Only a few provide for comprehensive property records.

NEED TO CHANGE

It has become obvious that management must change the manner in which they approach long-term tangible assets. The many production facilities built in the United States are wearing out. Government infrastructures of roads, sewers, sidewalks, and utilities are all suffering from the concept of "put it in place and forget about it."

The need is to get the most use out of these tangible assets. Much of the discussion having to do with inflation accounting for assets revolves around the problem that depreciation is not sufficient to cover the replacement costs of assets. The high cost of replacements, the dwindling supply of capital available, and high interest rates all require that new management control systems be put into place. With adequate control, management, and measurement of asset utilization, organizations can maximize the benefits from their investment in long-lived, tangible assets.

