What is Depreciation?

Fixed assets (eg: cars, fixtures and fittings, plant and machinery etc) can be used again and again until they wear out. During this time the value of many assets falls. This is called **depreciation**. Some fixed assets (eg: land and property) do not depreciate although they still have to be maintained and repaired.

**Questions:**

A machine costs £10 000 and is expected to have a useful life of four years. It is estimated that at the end of its life it will have a residual value of £2 000.

1. Calculate the depreciation charge and net book value for each year.
2. Explain how this would be accounted for on the Profit and Loss Account *and* the Balance Sheet.
3. State 3 factors that could influence the useful life of an asset.
4. If the residual valuation of £2 000 was incorrect, and actually the machine wasn’t worth anything at the end of the four years (in other words the firm had to ‘write-off’ the asset, or ‘write it down to zero’), explain the effect that would have on the company’s accounts.

**Write down 5 fixed assets that you might expect to find in a school or college:**

1

2

3

4

5

**Give 3 reasons (explain each) why fixed assets might fall in value:**

1

2

3

**Methods of Depreciation**

**1 Straight line method**

This is the most common method used to work out depreciation. It assumes that the net cost of an asset should be written off in equal amounts over its life. The accountant needs to know the cost of the asset, its estimated 'scrap' (or residual) value and its expected life in years. The formula used is:

 **Original cost - scrap value
Expected life (years)**

Assume you buy a vehicle for £12,000 and it has an expected life of 4 years. Its 'scrap' value is estimated to be £4,000. What is the depreciation allowance per year?

To see how this works in practice, go to the [Exchange and Mart homepage](http://www.exchangeandmart.co.uk) (<http://www.exchangeandmart.co.uk>) and carry out the following steps:-

* go to the used car price guide
* choose a 3 models of cars that have been around for a few years
* fill in the table below with their value on the most recent date available, and the oldest date available
* work out the depreciation allowance each year

|  |  |  |  |
| --- | --- | --- | --- |
| **Model / make** | **Price in year \_\_\_\_\_\_\_\_** | **Price in year \_\_\_\_\_\_\_\_** | **Depreciation allowance** |
|  |  |  |  |
|  |  |  |  |
|  |  |  |  |

How much does the rate of depreciation differ?

Go back to the [Exchange and Mart homepage](http://www.exchangeandmart.co.uk) (<http://www.exchangeandmart.co.uk>) and try another three cars. Try to find ones that you would expect to depreciate at different rates.

|  |  |  |  |
| --- | --- | --- | --- |
| **Model / make** | **Price in year \_\_\_\_\_\_\_\_** | **Price in year \_\_\_\_\_\_\_\_** | **Depreciation allowance** |
|  |  |  |  |
|  |  |  |  |
|  |  |  |  |

Did you succeed in finding different depreciation rates? If you did, why do you think this happened?

**Final Question:**

“Depreciation is based on estimates at best, and guesses at worst.’ Does this invalidate its use in accounting?”