Accounting Foundations

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10 Depreciation

If you buy a new computer system, an asset, for your business for £3,000, and then sell it the next day, you are not likely to get what you paid for it. Its reduction in value is called *depreciation*. Most assets depreciate over their lifetime. We see how depreciation is accounted for.

10.1 Fixed and Current Assets

Assets that are not permanent, such as stock for resale, debtors, bank accounts, and prepayments, are known as *current assets*. Current assets are not usually subject to depreciation.

But assets for permanent use in the business, such as premises, machinery, office furniture, and motor vehicles, are known as *fixed assets*. Fixed assets are usually subject to depreciation.

Premises - land and buildings - is a fixed asset? Its value usually appreciates (think of house prices going up year-by-year). Accountants say that buildings depreciate in value but land appreciates in value.

10.2 Calculating Depreciation

Perhaps the most common methods for calculating depreciation are the *straight line* (or fixed percentage) method, and the *reducing balance* method.

Straight Line

You buy a computer system for £3,000. Usually accountants reckon the value of computer equipment is reduced to zero over three years. So, the value of your computer system is reduced by £1,000 per year.

And again, you buy a vehicle for £10,000 and arbitrarily decide its value is reduced by 20% of its original purchase price per year. At the end of year one the vehicle is valued at £10,000 - £2,000 = £8,000. At the end of year two the vehicle is valued at £8,000 - £2,000 = £6,000. At the end of year three the vehicle is valued at £6,000 - £2,000 = £4,000. And so on until its value is zero.

Reducing Balance

You buy knitting machinery for £10,000. Suppose its value is reduced by 10% per year on the reducing balance. So its value at the end of year one is £10,000 - £1,000 = £9,000. Its value at the end of year two is £9,000 - £900 = £8,100. Its value at the end of year three is £8,100 - £810 = £7,290. And so on.

Straight line or reducing balance? It does not really matter. The important point is that you have made a provision for depreciation.

10.3 Accounting for Depreciation

The loss in value of an asset due to depreciation is treated as an expense in the Profit and Loss Account.

On 3 March we buy a computer system for £3,000.

DR		Computer Equipment			CR
		£			£
3 Mar	Bank	3,000			

At the end of our financial year we record the depreciation as a credit in the Provision for Depreciation of Computer Equipment Account and as a debit in the Profit and Loss Account.

DR		Provision for Depreciation of Computer Equipment			CR
		£			£
			31 Dec	To Profit & Loss A/c	1.000

DR		Trading and Profit and Loss Account for Period Ending 31 Dec			CR
		£			£
	Depreciation of Computer Equipment	1,000			

Depreciation is like an expense because it reduces profit, but it is not like an expense because no payment has been made. Depreciation is a non cash debit in the Profit and Loss Account.

In the Balance Sheet at year end we would write

Balance Sheet at 31 Dec

Liabilities	£	*Assets*	£
Computer Equipment (at cost)	3,000		
Less Provision for Depreciation	1,000		
	2,000		

Unlike an expense account, the balance in the Provision for Depreciation Account at year end is carried forward and not closed off. At the end of the third year our Provision for Depreciation of Computer Equipment Account might look like this.

DR	Provision for Depreciation of Computer Equipment				CR
		£			£
31 Dec Yr 1	Balance c/d	1,000	31 Dec Yr 1	To Profit & Loss A/c	1.000
31 Dec Yr 2	Balance c/d	2,000	1 JanYr 2	Balance b/d	1,000
			31 Dec Yr 2	To Profit & Loss A/c	1,000
		2,000			2,000
31 Dec Yr 3	Balance b/d	3,000	1 Jan Yr 3	Balance b/d	2,000
			31 Dec Yr 3	To Profit & Loss A/c	1,000
		3,000			3,000

Corresponding entries in the Trading and Profit and Loss Account for the three years are shown below.

DR	Trading and Profit and Loss Account for Period Ending 31 Dec		CR
		£	£
Year 1	Depreciation of Computer Equipment	1,000	
Year 2	Depreciation of Computer Equipment	1,000	
Year 3	Depreciation of Computer Equipment	1,000	

And the entries in the Balance Sheets for the three years is shown next.

Balance Sheet at 31 Dec

Liabilities	£	*Assets*	£
Year 1			
Computer Equipment (at cost)	3,000		
Less Provision for Depreciation	1,000		
	2,000		
Year 2			
Computer Equipment (at cost)	3,000		
Less Provision for Depreciation	2,000		
	1,000		
Year 3			
Computer Equipment (at cost)	3,000		
Less Provision for Depreciation	3,000		
	0		

Exercises 10.1

1 D Scent, a sole trader, purchases a delivery vehicle for £10,000. Construct two versions of the Vehicle Account for the first three years taking depreciation at 10% per year as it would appear

a under the straight-line method, and
b under the diminishing balance method

2 G Neuss, a sole trader, extracted the Trial Balance, shown below, on 31 March.

	DR	CR
	£	£
Capital		4,120
Stock	3,600	
Purchases & Sales	14,800	25,880
Discounts	640	220
Rent and Rates	1,300	
Cash	200	
Bank		1,660
Returns and Allowances	340	180
Debtors and Creditors	8,400	6,600
Wages and Salaries	6,220	
General Expenses	260	
Motor Vehicles (cost)	6,000	
Provision for Depreciation of Motor Vehicles		4,500
Fixtures and Fittings (cost)	3,000	
Provision for Depreciation of Fixtures and Fittings		1,600
	44,760	44,760

We have seen how to account for depreciation. **Next** we look at the disposal of fixed assets, and revaluations.

Bibliography

HARRISON W *Stage One Financial Accounting* Northwick Publishers 1986 pp 96..107