

Depreciation of Fixed Assets

WHAT IS DEPRECIATION

Depreciation^{Def} This is the loss in value of a Fixed asset over its useful economic life. The main cause of Depreciation includes – Wear and Tear, the asset being replaced, it has reached the end of its useful economic life, or time has run out (Lease on a property)

Why do business depreciate Fixed Assets?

If assets were not depreciated, then profit would be overstated, and the balance sheet would not show a true and fair view of the company. This would also go against the prudence concept. The prudence concept means that profit should not be overstated, or losses understated. If there is a class between the matching concept and the prudence concept the prudence concepts will be first. For example, Closing Stock and lower end of NRV and cost

How is depreciation estimated

The depreciation charge takes into four factors

1. The cost of the asset
2. The estimated economic life of the asset
3. The residual or scrap value of the asset
4. The method of depreciation

How to calculate Depreciation (Question 1 adjustment)

1. Find the value for the Fixed assets
2. Find the value of the Accumulate Depreciation
3. Find the value of This year Depreciation
4. Find the profit or loss on the disposal of the Fixed Asset

METHODS OF DEPRECIATION

There are two ways of calculating depreciation. These are

Straight line Method

This method reduces the value of the Fixed Asset by the same amount each year. This means that the same amount will be included as an expense in the profit and loss each year. Depreciation is divided equally to each year of the asset's economic life

Reducing Balance Method

This method reduces the Fixed Asset by a small amount each year. This amount of depreciation also reduces the value of the Fixed Asset

Each of the above methods are known as an accounting base. The method that is used by the company will become the accounting policy

Remember

A Fixed asset is a capital expense. This means that it is expected to last more than one year. This is why it can't be entered into the Profit and Loss in one year

SCRAP VALUE

Sometimes the business will want to have a scrap value or Residual value after the useful economic life. If this happens the following will be used

$$\frac{\text{Cost of the Assets} - \text{Residual Value (Scrap value)}}{\text{Useful economic life (years)}}$$