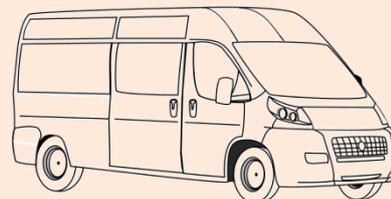




Depreciation

Think about it?

If you were to buy a new van for a business today that costs £16,000. How much would that fixed asset be worth in 5 years' time?



Assets will lose value over time as they are being used and as they age. This is what is known as **depreciation**. A business will need to be able to take into account this and record this form of **revenue expenditure**.

There are two different methods that can be used to calculate depreciation;

- **Straight-line Method**
- **Reducing Balance Method**

Straight-Line Method

This is the default method that is used by most organisations. It works on the idea that you gradually reduce the value of an asset until it reaches the end of its estimated life / scrap value.

To calculate the depreciation using this method though we need to know;

- **Initial value of the asset**
- **Estimated residual value**
- **Expected life of the asset**

Example

Bee purchases a new honey machine for £50,000. Bee has estimated that the machine will last for 5 years before being replaced. When Bee comes to sell the machine at the end of the 5 years it is estimated that the scrap value will be £5,000.

Step 1: Purchase Price - Estimated residual value

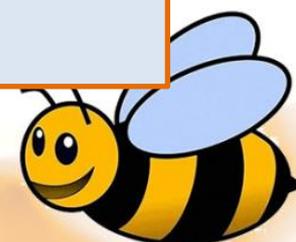
Step 1: £50,000 - £5,000

Step 1: Depreciable asset cost £45,000

Step 2: Depreciable asset cost / expected useful life

Step 2: £45,000 / 5

Step 2: £9,000 Depreciation cost per year





Reducing Balance Method

This is a little more complex. **The process is all about reducing the value of an asset by a set percentage each year.** This percentage figure will be determined by an accountant / Government and has to be recorded in the financial report. This has to be a realistic figure.

This method will work on the idea that an asset will reduce in value by a greater amount at first, before slowing down as it ages.

Example

Bee purchases a new honey machine for £50,000. Bee has estimated that the machine will last for 5 years before being replaced. It has been decided by the accountant that the asset should depreciate by 20% each year.

Historic Cost = £50,000

Year 1 depreciation = $£50,000 \times 0.20 = £10,000$
Net book value = $£50,000 - £10,000 = £40,000$

Year 2 depreciation = $£40,000 \times 0.20 = £8,000$
Net book value = $£40,000 - £8,000 = £32,000$

Year 3 depreciation = $£32,000 \times 0.20 = £6,400$
Net book value = $£32,000 - £6,400 = £25,500$

Year 4 depreciation = $£25,500 \times 0.20 = £5,120$
Net book value = $£25,500 - £5,120 = £20,380$

Year 5 depreciation = $£20,380 \times 0.20 = £4,076$
Net book value = $£20,380 - £4,076 = £16,304$

As you can see both methods give differing figures. It does not really matter which method is adopted, both have their own advantages and drawbacks. What is more important is that once a method is started to be used, it is consistently used throughout the life of that asset.

Now you have this help sheet. Download the depreciation worksheet and try and complete the questions.

