Depreciation of Fixed Assets Theory |

Accounting

Distinguish between the straight-line method and the diminishing balance method of depreciation. (2018):

- The straight-line method is where the same amount of the cost of the asset is written off each year. It is appropriate in the case of an asset that remains in the business over a long period of time and loses value slowly, for example assets such as buildings that generate profit over many years.
- The straight-line method involves spreading the depreciable amount evenly over the estimated useful life of the asset. Using this method, the depreciation is the same figure each year, which suggests that the asset is being used up at an even rate.
- The reducing balance applies a constant percentage to the gradually carrying amount balance so that the amount of depreciation expense diminishes over the useful life of the asset. The amount written off is high in early years and reduces each year until written off. This method is appropriate in the case of an asset which loses most of its value in the years immediately after purchase e.g. vehicles, computer, equipment etc., (assets that become obsolete quickly because of changes in technology).
- It should be noted that relatively few businesses use the reducing balance method and, where it is used, the percentage figure is often an approximation.

Explain what is meant by the term "depreciation", (2018):

Deprecation is the measure of loss in value of a fixed asset over its useful economic life as a result of wear and tear, passage of time, obsolescence and extraction. The amount allocated in each accounting period is treated as an expense to be set against revenue in the calculation of profit. Depreciation is an example of the matching concept in practice. The value of the asset is used up in the business (its depreciable amount) is matched to those accounting periods that are expected to benefit from it.

Why would a company choose one depreciation method over the other? (2013):

- Some companies have a depreciation policy.
- Straight line method: Chosen for assets that generate profits over many years (i.e. buildings).
- Reducing balance method: Chosen for assets that become obsolete quickly because of changes in technology (i.e. vehicles/computer).

Why do firms depreciate fixed assets?

- Assets lose value due to wear and tear.
- Assets lose value over a period of time.
- Certain assets become obsolete and are replaced by more modern machinery.
- Failure to depreciate fixed assets may result in profits being overstated.

What factors determine the annual charge for depreciation?

- The original cost of the asset.
- The estimated useful economic life of the asset.
- The estimated scrap/residual value of the asset.
- The method of depreciation being used for depreciating the asset.