Accounting for Non-Current Assets / Depreciation

Depreciation
Depreciation is that part of the original cost of a fixed asset that is consumed during its period of use by the business. It needs to be charged to profit and loss every year. The amount charged in a year to profit and loss for depreciation is based upon an estimate of how much of the overall economic usefulness of a fixed asset has been used up in that accounting period.

CAUSES OF DEPRECIATION

There are four causes of depreciation

1) **Physical deterioration**

   • Wear and tear (usage) e.g. Motor Vehicles, Machinery, Fixtures

   • Erosion, rust, rot and decay. E.g. metals, wood in assets

2) **Economic Factors**

   • Obsolescence (Process of becoming out of date) e.g. musical, medical equipment

   • Inadequacy (not up to the required use) e.g. boat, machine

3) **Time factor (due to time)** e.g. lease of building, patents (Amortization)

METHODS OF DEPRECIATION

1) **Straight Line / Cost Method.**

   Straight line method normally used for

   1) Furniture
   2) Fixtures & Fittings
   3) Buildings

Under straight line method, amount of depreciation remains same throughout its useful life.

$$\textbf{Straight line method} = \frac{\textbf{Cost - Scrap value}}{\textbf{Useful life}}$$

OR

(Cost - Scrap Value) X Rate%

Cost = Historical cost / Original cost / Purchase price / List price

Scrap value / salvage value / Residual Value

Useful life / estimated life / Life

Advantages of Straight line Method

- It is very simple, easy to understand and apply
- If we are generating equal benefit from a Non-Current Asset each year its cost shall also be spread equally. Straight line is the method which charges equal depreciation
- Asset can be depreciation to scrap value or zero, thus it helps to distribute full depreciable cost over useful life of the asset
- Every year, same amount is charged as depreciation to income statement, this makes comparison of profits of different years easy
- It is suitable for assets whose useful life can be estimated accurately and where the use of the asset is consistent from year to year

Disadvantages of Straight line Method

- This method is based on the unrealistic assumption of same utility of the asset in different accounting periods.
- As the asset gets older, repair and maintenance cost increases, but the depreciation remains the same, therefore increasing overall expense

2) Reducing Balance Method / Diminishing Balance Method:

Reducing Balance normally used for Technological Assets:

1) Machine
2) Equipment / Computers
3) Motor vehicles

Under reducing balance method amount of depreciation decreases year by year.

Reducing balance method = (Cost – Accumulated depreciation) x Rate%

Accumulated depreciation = Total depreciation / Provision for depreciation.

In the early years		*In the later years*
A higher charge for depreciation + A lower charge for repairs and upkeep	will tend to be fairly equal to	A lower charge for depreciation + A higher charge for repairs and upkeep

Advantages of Reducing Balance Method

• Technological assets such as Equipment, Motor Vehicles loose more of its value and utility in early years, therefore it is fair to charge higher depreciation in early years.
• In early years of life low repair and maintenance cost is incurred therefore higher rate of depreciation is charged and vice versa
• As the large proportion of cost is depreciation in early years, loss due to obsolescence gets reduced.

Disadvantages of Reducing Balance Method

• As depreciation is calculated as a percentage of NBV each year, the value of the asset can never be zero
• It is difficult to ascertain a suitable rate of depreciation

3) Revaluation Method

Revaluation method normally used for low cost items such as:

I) Loose tools
2) Laboratory items
3) Crockery

Asset NBV Account (Loose Tools, Crockery etc)

Balance b/d	xxx	Disposal	xxx
Bank / Payable (Addition)	xxx	**Income Statement** (Current Year Depreciation)	$\boxed{\textbf{xxx}}$
		Balance c/d	xxx
	xxx		**xxx**

Shortcut formula

Depreciation = Opening Value + Addition - Disposal - Closing Value

Advantages of Revaluation Method

• A more realistic depreciation expense used is charged to income statement
• Value in statement of financial position is realistic market value
• It is simple and straight forward to use
• Avoids the need for keeping detailed records

Disadvantages of Revaluation Method

• Value of the asset at end of the year is not an objective value rather it is just an opinion by the appraiser
• It produces a different figure for depreciation expense each year even when there is no difference in the use of asset
• To value the asset accurately at end of the year is time consuming

Policies for Charging Depreciation:

1) Charge full year's depreciation in the year of purchase of asset but no depreciation in the year of disposal **(Use when required in question or when dates are not given and no other information is given)**

2) Charge depreciation on Pro-rata / Time proportion basis
(Use when required in question or when dates are given in question)

DOUBLE ENTRY FOR DEPRECIATION

Income statement	xxx	
Provision for depreciation		xxx

(To record the depreciation expenses for the year)

DISPOSAL ENTRIES

1) **To write off cost of an asset**

Disposal account	xxx	
Machine/Vehicle/Equipment		xxx

(To write off an assets account on its disposal)

2. **To write off total depreciation charged from the date of purchase to date of sale.**

Accumulated Dep / Provision for depreciation	xxx	
Disposal Account		xxx

(To write off the total deprecation of the asset sold)

3. **To record the cash or cheque receipt on disposal**

Cash/Bank/Debtor	xxx	
Disposal account		xxx

(To record the cash or cheque received on sale)

4. To record the Gain or loss on disposal

Gain Entry

Disposal Account	xxx	
Income Statement (Gain)		xxx

(To record the gain on disposal)

Loss Entry

Income Statement (Loss)	xxx	
Disposal Account		xxx

(To record the loss on Disposal)

Asset Account (Equipment / Machine / Vehicle / Building)

Balance b/d	xxx	Disposal	xxx
Bank / Payables (Addition)	xxx	Balance c/d	xxx
	xxx		**xxx**
Balance b/d	xxx		

Provision for Dep / Accumulated Dep (Machine / Vehicle / Building)

Disposal	xxx	Balance b/d	xxx
Balance c/d	xxx	Income Statement (Current Year Depreciation)	xxx
	xxx		**xxx**
		Balance b/d	xxx

Disposal Account

(Machine / Vehicle / Building)	xxx	Provision for Dep / Acc Dep	xxx
Income Statement (Gain)	xxx	Bank / Cash / Debtor Name	xxx
		Income Statement (Loss)	xxx
	xxx		**xxx**

Income Statement Extract

Gross Profit		XXX
Add: Other Income		
Gain on Disposal of Asset		XX
		XXX
Less: Expenses		
Depreciation (Building)	XXX	
Depreciation (Equipment)	XXX	
Loss on Disposal of Asset	XXX	(XXX)

STATEMENT OF FINANCIAL POSITION EXTRACT

Non Current Assets	Cost	Accumulated Dep	NBV
Buildings	XXX	(XX)	XX
Equipment	XXX	(XX)	XX
Motor Vehicles	XXX	(XX)	XX
			XXX

Depreciation provisions and the replacement of assets

Making a provision for depreciation does not mean that money is invested somewhere to finance the replacement of the asset when it is put out of use. It is simply a bookkeeping entry, and the end result is that lower net profits are shown because the provisions have been charged to the profit and loss account.

Q. Why do we charge depreciation?

Ans. Depreciation is charged to spread the cost of asset over its useful life

Q. Why Land does not depreciate.

Ans. Because Land has an indefinite life.

Q. Explain why depreciation is in application of the matching/accruals principle

Ans. Accrual concept means recording of current year expenses and revenues in the current year, irrespective of expense paid or not and Income received or not. In deprecation we charge an expense against fixed asset for decrease in the value due to the different reasons, although there could be no cash outflow but we do record the depreciation expense every year.

Q. Depreciation is a non cash expense, Explain?

Ans. Depreciation is a non-cash expense the reason is that company does not pay any cash or cheque against depreciation expense, like other expense (Rent, Insurance)

DEPRECIATION

Q1 ARD Textiles started its operations on 1st Jan 2013. Its transactions relating to Non Current Assets are as follows:

1 Feb 2013 Machine at Cost $100,000
1 Aug 2014 2 Machines each at Cost $35000 from Honda Ltd
1 Sep 2016 It sold the machine which was bought in 2013 for $40000

Depreciation is at the rate of 15% Straight Line

Note: Full year Depreciation is charged in the year of purchase but no depreciation in the year of disposal

Required:
1) Machine Account
2) Provision for Depreciation Account
3) Disposal Account (Stating Gain / Loss on Disposal)
4) Income Statement and Balance sheet extracts

For the year ended 2013, 2014, 2015 and 2016

Now Resolve the question again if depreciation policy would have been 20% Reducing balance method

Revaluation Method

Revaluation method normally used for low cost items such as:

1) Loose tools
2) Laboratory items
3) Crockery

Asset NBV Account (Loose Tools, Crockery etc)

Balance b/d	xxx	Disposal	xxx
Bank / Payable (Addition)	xxx	Income Statement (Current Year Depreciation)	$\boxed{\text{xxx}}$
		Balance c/d	xxx
	xxx		xxx

Shortcut formula
= Opening Value + Addition - Disposal Value - Closing Value

Q2 Akram Garage started its Operations on 1st Jan 2015.
On 3rd Jan It bought new tools costing $50000 from ARD ltd
At 31 Dec 15 tools were valued at $45000

On 4th Feb 16 It bought new tools costing $75000 and some old tools that were originally bought in 2015 for $10000 were sold for $6000. Value of tools remaining at 31 Dec 16 was $87000

On 15 Mar 2017 one of the tool costing $5000 in 2015 with a value of $4000 was sold for $3000. Value of tools remaining at 31 Dec 17 was $70000

Required: Depreciation for the year 2015, 2016 and 2017 using Revaluation method.

Q3 Kolachi Restaurant started its Operations on 1st Jan 2016.
On 8th Jan It bought new crockery costing $10000 from Crockery ltd
At 31 Dec 16 Plates were valued at $8500

On 4th Feb 17 It bought new Glasses $7500 and some old glasses that were originally bought in 2016 for $1000 with the value of $900 were sold for $1100. Value of the crockery remaining at 31 Dec 17 was $87000

On 15 Mar 18 one of the Jug costing $500 in 2016 having a value of $400 was sold for $300. Value of crockery remaining at 31 Dec 18 was $11000

Required: Depreciation for the year 2016, 2017 and 2018 using Revaluation method.

Q4 On 31 August 2011 the following extract was taken from the balance sheet of Stavros.

Non-current assets	Cost	Accumulated depreciation	NBV
	$	$	$
Equipment	60 000	24 000	36 000
Office Computers	8 000	5 600	2 400
	68 000	29 600	38 400

The following transactions took place during the year ended 31 August 2012:

1 On 31 January 2012, equipment purchased on 1 April 2009, at a cost of $28 000, was sold for $10 000. Payment was received by cheque.

2 On 1 February 2012, new equipment was purchased at a cost of $35 000.

3 On 20 March 2012, office computers were purchased for $600.

Stavros has the following depreciation policy:

Equipment is depreciated at the rate of 20% per annum using the straight-line method.

Office computers are depreciated at the rate of 25% per annum using the diminishing (reducing) balance method.

A full year's depreciation is charged on equipment and office computers in the year of purchase.

No depreciation is charged on equipment in the year of sale.

REQUIRED

(a) **(i)** Explain the term depreciation.

....

....

....[2]

(ii) State **two** causes of depreciation.

1 ....

2 ....[2]

(b) State **one** advantage of using the straight-line method of depreciation.

....

....

....[2]

(c) Prepare the following ledger accounts for the year ended 31 August 2012:

(i) Provision for depreciation of equipment account

....

....

....

....

....

....

....

....

(ii) Equipment disposal account

....

....

....

....

....

....

....

....[8]

(d) Complete the following balance sheet (extract) for the non-current assets on 31 August 2012.

Non-current assets	Cost	Accumulated depreciation	NBV
	$	$	$
Equipment			
Office Computers			

[6]

Q5. Sarah runs a wholesale business. An extract from her statement of financial position (balance sheet) at 31 December 2009 shows:

Motor vehicles at cost	\$371 000
Motor vehicle accumulated depreciation	\$130 000

During the financial year ended 31 December 2010 the following transactions took place.

1 A motor vehicle purchased on 1 January 2006 for \$9200 was sold on 30 June 2010 for \$500.

2 A motor vehicle was purchased on 1 April 2010 for \$15 000.

Depreciation is charged at 20% per annum on cost, with the rate being applied for each part of the year. No allowance is made for any residual value.

All motor vehicles held by the company at 31 December 2010 had been purchased within the previous five years.

All transactions are by cheque.

REQUIRED

(a) Prepare the following ledger accounts for the year ended 31 December 2010.

(i) Motor vehicles account

....

....

....

....

....

....

.... [4]

(ii) Provision for depreciation of motor vehicles account

....

....

....

....

....

....[4]

(iii) Motor vehicle disposal account

....

....

....

....

....

....[4]

(b) Prepare an extract from the statement of financial position (balance sheet) for non-current assets at 31 December 2010.

....

....

....

....

....[2]

Q6. SMC Limited is a wholesale business. An extract from their statement of financial position at 31 December 2012 showed:

Non-current Assets

	$	$	$
Fittings and fixtures	240 000	96 000	144 000
Equipment	60 000	18 000	42 000

SMC Ltd has a policy to depreciate fittings and fixtures at 20% per annum on cost (straight line method) and equipment at 10% per annum on cost. Depreciation is charged for each month of ownership.

No allowance is made for any residual value.

All fittings and fixtures held by the company at the end of the financial year had been purchased within the previous four years. All equipment had been purchased within the previous seven years.

During the year ended 31 December 2013 the following transactions took place:

Purchases

1 January 2013 fittings and fixtures $16 000, purchased on credit from Walker.
1 July 2013 equipment $14 000, purchased on credit from Arcadia Limited.

Disposals

31 March 2013 equipment (original cost $8 000, bought on 1 January 2010) was sold for $6 000.

Disposal proceeds were received in full by cheque.

REQUIRED

(a) Prepare journal entries to record the following (narratives are not required).

(i) The purchase of the equipment.

Account	Debit $	Credit $

[2]

(ii) The depreciation charge for fittings and fixtures for the year ended 31 December 2013.

Account	Debit $	Credit $

[4]

(iii) The depreciation charge for equipment for the year ended 31 December 2013.

Account	Debit $	Credit $

[4]

(iv) The disposal of equipment.

Account	Debit $	Credit $

[8]

(b) (i) Explain the purposes of the journal.

....

....

....

....

....

.... [2]

(ii) State two examples of transactions which would be recorded in the journal, other than the purchase of non-current assets on credit.

1 ....

2 .... [2]

Additional information

SMC is considering changing the depreciation method for equipment to reducing balance method.

REQUIRED

(c) (i) State an accounting concept which is applied when depreciation is provided.

.... [1]

(ii) Explain the possible reasons why the business is considering this change.

....

....

....

....

....

....

.... [7]