

Depreciation

A fixed asset reduces in value over its useful life due to wear and tear and (when it is no longer useful) obsolescence. Depreciation is the tool used by accountants to record the reduction in the original value of an asset. Depreciation is charged every year of a fixed asset's useful life to the profit and loss account. In the balance sheet the original cost of the fixed asset is reduced by the amount of depreciation.

There are two main methods of depreciation:

- ▶ **Straight line depreciation** – this is where the same amount is charged every year using the following formula to calculate it:

$$\text{Original Cost of the Fixed Asset} / \text{Useful Life of the Asset}$$

For example; a machine bought for £20,000 has a useful life of ten years. Management decide to charge depreciation on a straight line basis. So the annual depreciation cost is $£20,000 / 10 = £2,000$

- ▶ **Reducing balance depreciation** – the same percentage of an asset's value is taken off every year, e.g. 20%.

Most businesses use straight line depreciation, but it is possible to argue that reducing method is better because it reflects the fact that most assets lose most of their value in the first years of use.

Depreciation appears in the profit and loss account under expenses – it reduces the profit for that year because some of the asset was used up in that time period.

It appears in the balance sheet by reducing the value of the fixed assets. This means that the balance sheet reflects a true and fair value of the assets.

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