THE INSTITUTE OF EDUCATION

# Subject: Accounting

TEACHER: John Taylor

COURSE: 5th Year Day School

ACADEMIC LEVEL: Higher

ACADEMIC YEAR: 2020/2021

## *TOPIC: Depreciation*

CONTENTS



## (A) Exam Analysis

Depreciation has been asked as an examination question with the following frequency:

| **Higher Level** | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Year** | **2020** | **2019** | **2018** | **2017** | **2016** | **2015** | **2014** | **2013** | **2012** | **2011** | **2010** | **2009** |
| **Q** | | | **2** | | | **2** | | **2** | | | **3** | |
| **Year** | **2008** | **2007** | **2006** | **2005** | **2004** | **2003** | **2002** | **2001** | **2000** | **1999** | **1998** | **1997** |
| **Q** | | | | **3** | | | **2** | | | **2** | | |

## (B) Introduction to Depreciation

Depreciation is defined as "the loss in value of a fixed asset due to wear and tear, the passing of time or obsolescence."

***Fixed Asset*:** Something of value, which the business owns and will be expected to hold onto for more than one year e.g. buildings, machinery, equipment or motor vehicles

***Wear and tear*:** Using the asset on a regular basis

***Passing of time:*** Age of the asset/length of time the asset remains in the firm

***Obsolescence:*** Going out of date or fashion.

## (C) Calculation of Depreciation

Depreciation can be calculated in one of three ways:

- A percentage of the cost price (straight line)
- A percentage of the book value (reducing balance)
- Based on the estimated life and scrap value of the asset using the following formula:

$$\frac{\textbf{Cost of asset – Scrap value}}{\textbf{Estimated life}}$$

The depreciation is then recorded in the profit and loss account where it is written off against profits each year.

## (D) Accounts

The following accounts should be prepared in a question on the depreciation of fixed assets.

### (1) The Fixed Asset Account

This account records the following:

**Dr** ............. Opening value of fixed assets (include any additions such as refrigeration units or tachographs)
**Dr** ............. Assets purchased during the year at **cost price**
**Cr** ............. Assets sold/disposed of during the year at **cost price**
**Cr** ............. The closing balance (carried down) of fixed assets at the end of this year
**Dr** ............. The opening balance (brought down) of fixed assets at the beginning of the next year

**Remember:** **All assets are shown at cost price in the fixed asset account.**
**Rule:** **Dr ....Assets purchased**
**Cr ....Assets sold/disposed of**

### (2) The Provision for Depreciation Account

This account records the following:

**Cr** ............. Opening accumulated depreciation total i.e. all depreciation charged on the fixed assets up to the beginning of the year you are required to show the accounts for in the question
**Cr** ............. The depreciation charge for the year you are required to prepare
**Dr** ............. The accumulated depreciation on any assets sold/disposed of during the year you are required to prepare
**Dr** ............. The closing balance (carried down) on the provision for depreciation account this year
**Cr** ............. The opening balance (brought down) on the provision for depreciation account at the beginning of the next year

**Rule:** **Dr ....Accumulated dep. on assets sold/disposed of during the year.**
**Cr ....Annual depreciation charge**

### (3) The Disposal of Fixed Asset Account

This account shows the profit or loss made on each of the assets disposed. The following should be recorded in this account:

**Dr** ............. Cost price of the asset sold including any additions e.g. refrigeration unit etc.
**Cr** ............. Total accumulated depreciation on the asset sold
**Cr** ............. Receipts from the sale/disposal of the asset including cash, trade-in value and insurance

The difference remaining in the account represents the profit or loss made on sale.
**Dr** ............. Profit made
**Cr** ............ Loss incurred

***Tip***

This question is all about the workings for the Provision for Depreciation Account so you should do all the workings first – column by column!

## (E) Sample Question and Solution – Higher Level (Cost Method)

***Assignment 1 – 2018 Q2***

O'Brien Transport Ltd prepares its final accounts to 31 December each year. The company's policy is to depreciate its vehicles at the rate of **15% of cost per annum** calculated from the date of purchase to the date of disposal and to accumulate this depreciation in a provision for depreciation account.

On 01/01/2016, O'Brien Transport Ltd owned the following vehicles:

No. 1 purchased on 01/01/2012 for €50,000
No. 2 purchased on 01/03/2013 for €66,000
No. 3 purchased on 01/10/2014 for €74,000

On 01/04/2016, vehicle no. 3 was crashed and traded in against a new vehicle costing €86,000. The company received compensation to the value of €43,000 and the cheque paid for the new vehicle was €65,000.

On 31/07/2017, vehicle no. 1 was traded in for €13,000 against a new vehicle costing €90,000. Vehicle no. 1 had a refrigeration unit fitted on 01/01/2013 costing €22,000. This refrigeration unit was depreciated at the rate of 30% of cost for each of the first two years and thereafter at the rate of 15% of cost per annum.

**You are required to show, with workings, for each of the two years 2016 and 2017:**

**(a)** The vehicles account
**(b)** The provision for depreciation account
**(c)** The vehicles disposal account
**(d)** (i) Explain what is meant by 'depreciation'.
(ii) Distinguish between the straight line method and reducing balance method of depreciation.

***<u>Solution</u>***

**Workings**

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| Dr | | Vehicles Account no. 1 | | | Cr |
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| Dr | Provision for Depreciation Account no. 2 | | | | Cr |
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| Dr | Vehicles Disposal Account no. 3 | | | | Cr |
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***Assignment 2 – 2015 Q2***

Euro Ltd, a sportswear manufacturer, prepares its final accounts to 31 December each year. The company's policy is to depreciate its machinery on a straight line basis over 10 years. Scrap value is estimated at 5% of the original cost of the machine. Depreciation is charged from the date of purchase to the date of sale. (Calculations should be to the nearest euro.)

On 01/01/2013, Euro Ltd owned the following machines:

No. 1 purchased on 01/07/2010 for €50,000
No. 2 purchased on 01/09/2011 for €65,000
No. 3 purchased on 01/01/2012 for €75,000

On 01/03/2013, Machine No. 1 was ruined by a malfunction which completely destroyed the motor sensor. The insurance company paid out €25,000 in respect of this damage and €500 was received from the sale of the machine to a scrap dealer. On the same date a new Machine, No. 4, was purchased to replace Machine No. 1 at a cost of €60,000.

Machine No. 3 had modifications carried out on its motor to increase productivity on 01/01/2014 costing €4,000. The depreciation on this modification is €475 per year.

On 01/04/2014, Machine No. 2 was traded in for €27,500 against a new Machine, No. 5, costing €55,000. The balance of the purchase price was paid immediately. It cost €2,000 to have the machine delivered and €400 to have it installed.

**You are required to show, with workings, the following accounts for each of the two years 2013 and 2014:**

**(a)** The Machinery Account.
**(b)** The Provision for Depreciation Account.
**(c)** The Machinery Disposal Account.
**(d)** (i) Explain why a company charges depreciation in calculating profit.
(ii) List the factors which should be considered when determining the depreciation policy on a particular asset.

***<u>Solution</u>***

**Workings**

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| Dr | | Machinery Account no. 1 | | | Cr |
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| Dr | | Provision for Depreciation Account no. 2 | | | Cr |
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| Dr | | Machinery Disposal Account no. 3 | | | Cr |
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***Assignment 3 – 2013 Q2***

Blue Haulage Ltd prepares its final accounts to 31 December each year. The company's policy is to depreciate its vehicles at the rate of 15% of cost per annum, calculated from the date of purchase to the date of disposal and to accumulate this depreciation in a Provision for Depreciation Account. (Calculations to the nearest Euro.)

On 01/01/2011, Blue Haulage Ltd owned the following vehicles:

No. 1 purchased on 01/01/2007 for €50,000
No. 2 purchased on 01/04/2008 for €60,000
No. 3 purchased on 01/09/2009 for €70,000

On 01/09/2011, Vehicle No. 1 was traded in for €20,000 against a new vehicle costing €75,000. Vehicle No. 1 had a refrigeration unit fitted on 01/01/2009 costing €15,000. This refrigeration unit was depreciated by 30% for the first two years and thereafter at the same rate as Vehicle No. 1. On 01/04/2012, Vehicle No. 3 was crashed and traded in against a new vehicle costing €86,000. The company received compensation from the insurance company to the value of €25,000 and the Profit and Loss Account at 31/12/2012 showed a profit on disposal of €1,125 for Vehicle No. 3.

**You are required to show, with workings, for each of the two years 2011 and 2012:**

(a) The Vehicles Account.
(b) The Provision for Depreciation Account.
(c) The Vehicles Disposal Account.
(d) (i) Why does a company charge depreciation in calculating profit?
    (ii) Why would a company choose one method of depreciation over another?

***<u>Solution</u>***

**Workings**

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| Dr | | Vehicles Account no. 1 | | | Cr |
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| Dr | Provision for Depreciation Account no. 2 | | | | Cr |
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| Dr | Vehicles Disposal Account no. 3 | | | | Cr |
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***Assignment 4 – 2005 Q3***

Ace Haulage Ltd. prepares its final accounts to 31st December each year. The company's policy is to depreciate its vehicles at the rate of **15% of Cost** per annum calculated from the date of purchase to the date of disposal and to accumulate this depreciation in a Provision for Depreciation Account.

On 1/1/2003, Ace Haulage Ltd. owned the following vehicles:

No. 1 purchased on 1/1/1999 for €70,000
No. 2 purchased on 1/8/2000 for €80,000
No. 3 purchased on 1/4/2001 for €88,000

On 1/5/2003, Vehicle No. 2 was crashed and traded in against a new vehicle costing €90,000. The company received compensation to the value of €30,000 and the cheque paid for the new vehicle was €75,000. On 1/7/2004, Vehicle No. 1 was traded in for €24,000 against a new vehicle costing €95,000. Vehicle No. 1 had a refrigeration unit fitted on the 1/1/2001 costing €20,000. This refrigeration unit was depreciated at the rate of 30% of cost for the first two years and thereafter at the rate of 15% of cost per annum.

**You are required to show, with workings, for each of the two years 2003 and 2004:**

**(a)** The Vehicles Account.
**(b)** The Vehicle Disposal Account.
**(c)** The Provision for Depreciation Account.
**(d)** What factors are taken into account in arriving at the annual depreciation charge?

***Solution***

**Working**

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| Dr | Provision for Depreciation Account no. 2 | | | | Cr |
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| Dr | Vehicles Disposal Account no. 3 | | | | Cr |
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***Assignment 5 – 2002 Q2***

Trench Transport Ltd prepares its final accounts to the 31st December each year. The company's policy is to depreciate its vehicles at the rate of 15% of cost per annum calculated from the date of purchase to the date of disposal and to accumulate this depreciation in a Provision for Depreciation Account.

On 1/1/2000 Trench Transport Ltd owned the following vehicles:

No 1 purchased on 1/1/1996 for €66,000
No 2 purchased on 1/9/1997 for €72,000
No 3 purchased on 1/3/1998 for €78,000

On 1/4/2000 Vehicle No 3 was crashed and traded in against a new vehicle costing €96,000. The company received compensation to the value of €28,000 and the cheque paid for the new vehicle was €57,000. On 1/8/2001 Vehicle No 1 was traded in for €12,000 against a new vehicle costing €90,000. Vehicle No 1 had a refrigeration unit fitted on 1/1/1998 costing €16,000. This refrigeration unit was depreciated at the rate of 30% of cost for each of the first two years and thereafter at the rate of 15% of cost per annum.

**You are required to show, with workings, for each of the two years 2000 and 2001:**

**(a)** The Vehicles Account
**(b)** The Provision for Depreciation Account
**(c)** The Vehicles Disposal Account

***<u>Solution</u>***

**Workings**

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| Dr | | Vehicles Account no. 1 | | | Cr |
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***Assignment 6 – 1999 Q2***

Speedo Transport Ltd prepares its final accounts to the 31st December each year. The company's policy is to depreciate its vehicles at the rate of 15% of cost per annum calculated from the date of purchase to the date of disposal and to accumulate this depreciation in a Provision for Depreciation Account.

On 1/1/1997 Speedo Transport Ltd owned the following vehicles:

No 1 purchased on 1/1/1993 for €60,000
No 2 purchased on 1/9/1994 for €68,000
No 3 purchased on 1/3/1995 for €72,000

On 1/4/1997 Vehicle No 3 was crashed and traded in against a new vehicle costing €76,000. The company received compensation to the value of €25,000 and the cheque paid for the new vehicle was €54,000. On 1/8/1997 Vehicle No 1 was traded in for €20,000 against a new vehicle costing €78,000. Vehicle No 1 had a refrigeration unit fitted on 1/1/1995 costing €15,000. This refrigeration unit was depreciated at the rate of 30% of cost for each of the first two years and thereafter at the rate of 15% of cost per annum.

You are required to show, with workings, for each of the two years 1997 and 1998:
(a) The Vehicles Account
(b) The Provision for Depreciation Account
(c) The Vehicles Disposal Account

***<u>Solution</u>***

**Workings**

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# (F) Sample Question & Solution – Higher Level (Book Value Method)

***Assignment 7 – 2010 Q3***

Trans Haulage Ltd prepares its final accounts to 31st December each year. The company's policy is to depreciate its vehicles at the rate of **<u>20% of Book Value</u> (reducing balance)** per annum, calculated from the date of purchase to the date of disposal and to accumulate this depreciation in a Provision for Depreciation Account. (Calculations to the nearest Euro.)

On 01/01/2008, Trans Haulage Ltd owned the following vehicles:

No. 1 purchased on 01/01/2004 for €40,000
No. 2 purchased on 01/01/2005 for €50,000
No. 3 purchased on 01/01/2006 for €60,000

On 01/08/2008, Vehicle No. 1 was traded in for €12,000 against a new vehicle costing €66,000. Vehicle No. 1 had a refrigeration unit fitted on 01/01/2007 costing €16,000. This refrigeration unit was depreciated at the rate of 40% for the first year and thereafter at the same rate as Vehicle No. 1. On 01/05/2009, Vehicle No. 3 was crashed and traded in against a new vehicle costing €72,000. The company received compensation from the insurance company to the value of €20,000 and the cheque paid for the new vehicle was €61,000.

**You are required to show, with workings, for each of the two years 2008 and 2009:**

(a) The Vehicles Account.
(b) The Provision for Depreciation Account.
(c) The Vehicles Disposal Account.
(d) (i) Explain what is meant by depreciation.
(ii) Why does a company charge depreciation in calculating profit?

***<u>Solution</u>***

**Workings**

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| Dr | | Provision for Depreciation Account no. 2 | | | Cr |
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| Dr | | Vehicles Disposal Account no. 3 | | | Cr |
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***Assignment 8 – Sample Question 1***

North Western Transport Ltd prepares its final accounts to 31st December each year. The company's policy is to depreciate its vehicles at the rate of **<u>20% of Book Value</u> (reducing balance)** per annum, calculated from the date of purchase to the date of disposal and to accumulate this depreciation in a Provision for Depreciation Account. (Calculations to the nearest Euro.)

On 01/01/2018, Trans Haulage Ltd owned the following vehicles:

No. 1 purchased on 01/01/2015 for €40,000
No. 2 purchased on 01/01/2016 for €48,000
No. 3 purchased on 01/01/2017 for €50,000

On 01/07/2018, Vehicle No. 1 was traded in for €6,000 against a new vehicle costing €55,000. Vehicle No. 1 had a tachograph fitted on 01/01/2016 costing €5,000. This tachograph was depreciated at the rate of 36% for the first year and thereafter at the rate of 20% of book value. On 01/04/2019, Vehicle No. 3 was crashed and traded in against a new vehicle costing €60,000. The company received compensation from the insurance company to the value of €20,000 and the cheque paid for the new vehicle was €45,000.

**You are required to show, with workings, for each of the two years 2018 and 2019:**

**(a)** The Vehicles Account.
**(b)** The Provision for Depreciation Account.
**(c)** The Vehicles Disposal Account.

***<u>Solution</u>***

**Workings**

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| Dr | | Vehicles Account no. 1 | | | Cr |
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| Dr | Provision for Depreciation Account no. 2 | | | | Cr |
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| Dr | Vehicles Disposal Account no. 3 | | | | Cr |
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***Assignment 9 – Sample Question 2***

Long Haul Transport Ltd prepares its final accounts to 31st December each year. The company's policy is to depreciate its vehicles at the rate of **<u>20% of Book Value</u> (reducing balance)** per annum, calculated from the date of purchase to the date of disposal and to accumulate this depreciation in a Provision for Depreciation Account. (Calculations to the nearest Euro.)

On 01/01/2018, Trans Haulage Ltd owned the following vehicles:

No. 1 purchased on 01/01/2014 for €50,000
No. 2 purchased on 01/01/2015 for €55,000
No. 3 purchased on 01/01/2016 for €60,000

On 01/08/2018, Vehicle No. 1 was traded in for €17,000 against a new vehicle costing €65,000. Vehicle No. 1 had a tachograph fitted on 01/01/2016 costing €5,500. On 01/05/2019, Vehicle No. 3 was crashed and traded in against a new vehicle costing €68,000. The company received compensation from the insurance company to the value of €10,000 and the cheque paid for the new vehicle was €42,000.

**You are required to show, with workings, for each of the two years 2018 and 2019:**

(a) The Vehicles Account.
(b) The Provision for Depreciation Account.
(c) The Vehicles Disposal Account.

***<u>Solution</u>***

**Workings**

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## (G) Theory

1) **Explain what is meant by "depreciation".**
Depreciation is the loss in value of a fixed asset (e.g. motor vehicles, machinery) over time for any of the following reasons:
- Passing of time i.e. age
- Wear and tear i.e. usage
- Obsolescence i.e. going out of date/fashion

2) **Distinguish between the straight line method and reducing balance method of depreciation.**

***Straight Line***
Here, the fixed asset is reduced by an equal amount each year. This may be a given percentage e.g. 20% or may be calculated using the following formula:

$$\frac{\text{Cost Price} - \text{Scrap Value}}{\text{Estimated Life}}$$

***Reducing Balance***
Here the amount of the depreciation taken off the asset reduces each year as the value of the asset reduces. A fixed percentage of the cost of the asset is calculated in year one and each year after that, the same percentage is applied to the book value of the asset at the end of the previous year.

**Example**
Year 1 – 20% of €50,000 = €10,000
Year 2 – 20% of €40,000 i.e. €50,000 - €10,000 = €8,000
Year 3 – 20% of €32,000 i.e. €40,000 - €8,000 = €6,400

3) **Explain why a company charges depreciation in calculating profit**
A company charges depreciation in calculating profit for the following reasons:
- Depreciation is an allowable expense for the business and so they can reduce the profits accordingly and as a result pay less tax
- If depreciation was not included, the profits and as a result the company net worth would be overstated and as such would not be a "true and fair view" of the company's financial position

4) **Why would a company choose one method of depreciation over another?**
A company would choose different methods of depreciation depending on:
- Methods they have used in the past – consistency!
- If the asset is expected to remain in the business in the long term e.g. buildings, they might choose a straight line method
- If the asset is expected to lose its value in the early years e.g. technology, they might choose a reducing balance method which would result in a greater amount of depreciation being charged in the earlier years of the assets life

5) **What factors are taken into account in arriving at the annual depreciation charge?**
The factors to be taken into account in arriving at the annual depreciation charge are:
- Type of asset
- Estimated life of the asset
- The cost of asset
- Method of depreciation to be used