

## 27.2 Some exercises on the nature of depreciation

### 1.

Simon inherits £20 000 from his uncle, and uses it to buy a fixed asset in order to start a new business. At the end of the accounting period, Simon has attracted no customers, and has engaged in no further transactions. Has he made a profit or a loss for the period? Explain your answer.

#### Response

Simon starts with £20 000 of value in the form of money. When he buys the fixed asset, he exchanges £20 000 of money for £20 000 of fixed asset. There is no profit or loss at this stage. However, it is reasonable to assume that a fixed asset will lose value over the course of time, even if it is not used. Thus Simon will end the period with a fixed asset which embodies less than £20 000 of value. He will therefore make a loss in the period.

### 2.

What are the objects of accounting for depreciation?

#### Response

The **main** object of providing for depreciation is to match the cost of holding or using a fixed asset against the revenues derived from its use.

### 3.

What would happen if we failed to account for depreciation?

#### Response

Failure to account for depreciation would mean that a firm's reported profits would be overstated. Certain activities might appear to be more profitable than they actually are, and, under the mistaken impression that profits are bigger than they actually are, owners of firms might withdraw and spend too much value from the firm, and thus unwittingly reduce the value of their investment and consume their capital.