

29.4 A drill to show how the profit or loss on disposal works to correct previous errors in the estimation of value lost by a fixed asset

Business 1

A fixed asset is acquired at cost £120 000 in YEAR 1. In YEAR 3 the fixed asset is disposed of for £57 500.

Treating each assumption separately, show how the actual loss in value of the fixed asset would have been accounted for in the P&L Accounts of YEAR 1, YEAR 2, and YEAR 3:

1. if the business believed that the fixed asset would lose 25% of its original value in each year of use
2. if the business believed that in each year of use, the fixed asset would lose 25% of the value it had at the start of the year.

Response

The actual loss in value of the fixed asset is

$$£120\,000 - £57\,500 = £62\,500$$

This would have been accounted for as follows:

under assumption 1		under assumption 2	
<div>P&L 1</div> <hr/> <div>depreciation 30 000</div>		<div>P&L 1</div> <hr/> <div>depreciation 30 000</div>	
<div>P&L 2</div> <hr/> <div>depreciation 30 000</div>		<div>P&L 2</div> <hr/> <div>depreciation 22 500</div>	
<div>P&L 3</div> <hr/> <div>loss on disposal 2 500</div>		<div>P&L 3</div> <hr/> <div>loss on disposal 10 000</div>	

Business 2

A fixed asset is acquired at a cost of £20 000 in YEAR 1. In YEAR 3 the fixed asset is disposed of for £16 500.

Treating each assumption separately, show how the actual loss in value of the fixed asset would have been accounted for in the P&L Accounts of YEAR 1, YEAR 2 and YEAR 3:

1. if the business believed that the fixed asset would lose 10% of its original value in each year of use
2. if the business believed that the fixed asset would lose £3 000 of value in YEAR 1, and £2 000 of value in YEAR 2.

Response

The actual loss in value of the fixed asset is

$$£20\,000 - £16\,500 = £3\,500$$

This would have been accounted for as follows:

under assumption 1		under assumption 2	
P&L 1 <hr/> <div> <div>depreciation</div> <div>2 000</div> </div>		P&L 1 <hr/> <div> <div>depreciation</div> <div>3 000</div> </div>	
P&L 2 <hr/> <div> <div>depreciation</div> <div>2 000</div> </div>		P&L 2 <hr/> <div> <div>depreciation</div> <div>2 000</div> </div>	
P&L 3 <hr/> <div> <div></div> <div>profit on disposal</div> <div>500</div> </div>		P&L 3 <hr/> <div> <div></div> <div>profit on disposal</div> <div>1 500</div> </div>	