

31.2 An exercise on the choice of different methods of estimating annual depreciation

Identify the depreciation policy that might probably be applied to each of the following fixed assets:

1. a 20-year lease on land and buildings

This would most likely be depreciated on a straight line basis, although if the firm ever intended to sell the lease, it would probably find that the loss in value tended to accelerate with the passing of time

2. antique fixtures and fittings in the boardroom of a large company

It would seem unlikely that these particular fixed assets would suffer or be allowed to suffer much loss in value from the usual causes. The appropriate depreciation policy therefore would be a matter of debate. A prudent management might account for depreciation at say 20% per year on the reducing balance. A less prudent policy would be to avoid charging depreciation at all, or to rely on some informal annual valuation

3. a freehold building kept in good repair

Freehold buildings are often depreciated at 2% per year on cost. There may be an argument that a building kept in good repair does not in fact lose value, but in the context of technological change and the movement of economic activity from one region to another over time, it does seem prudent to account for some degree of depreciation

4. a computerized accounting system

At current rates of technological change in software development, and with no scrap value at the end of its life, it would be prudent to account for depreciation on this as rapidly as possible, say at 25% or more per year on cost

5. freehold land

Usually, there is no systematic accounting for depreciation on freehold land. However, depreciation may from time to time be charged if the land suffers a permanent fall in value (perhaps because of regional economic decline, or exposure to risks such as flooding)

6. a passenger aircraft

Since careful usage records must be kept for safety purposes, it would seem quite possible and desirable to account for depreciation on passenger aircraft on a usage basis, although for accounting convenience, it is quite likely that aircraft depreciation is accounted for on a straight line basis

7. a motor vehicle

The market value of a motor vehicle declines sharply at the beginning of its life. For this reason perhaps depreciation should be charged on the reducing balance, even though in practice it is most likely charged on a straight line basis

8. a durable machine expected to have a long useful life

Depreciation would probably be charged at a low annual rate on the straight line basis

9. a new factory built by a military uniform manufacturer at the start of a war, to cater for increased demand (when such equipment would normally have a useful life of 10 years)

If the factory is built solely to cater for the extra demand generated by the war, then depreciation should be charged over the expected life of the war – assuming that the war will be shorter than the expected life of the factory