

31.3 An exercise on the effects of depreciation policy

1. You are the financial director of a company which has just started, with high investment in fixed assets. Investors in the firm are prepared to tolerate low profits in the early years, as the new firm establishes itself, but they do expect profits to rise steadily over time.

State the depreciation policy you would advise your fellow directors to adopt, and explain why.

Response

Depreciation on the reducing balance results in a depreciation charge which declines with the passage of time. Other things being equal, this will result in lower reported profits initially, and higher reported profits later. As this pattern of reported profits is what investors expect, this is probably what a financial director would choose to do in the circumstances.

2. State the effect on reported profits of the following changes in accounting assumptions:

a) longer asset lives

will in general lead to lower annual depreciation charges in the P&L Account, and therefore to higher reported profits

b) higher residual values (that is, higher expected disposal proceeds)

will in general lead to lower annual depreciation charges in the P&L Account, and therefore to higher reported profits

c) faster technological change in the industry

will in general lead to shorter asset lives and lower residual values and thus to higher annual depreciation charges in the P&L Account, and therefore to lower reported profits

d) shorter asset lives

will in general lead to higher annual depreciation charges in the P&L Account, and therefore to lower reported profits