



Depreciation

Depreciation is the term used for the 'wearing out' or 'reduction in value' of an asset over the course of its life.

Although this reduction in value is not 'paid for' with a cheque like other business expenses, it is nevertheless a 'cost' to the enterprise.

Because it is not a 'payment' by cheque (or cash), it does not appear in the cash flow forecast (or in the bank statements). Yet it does appear in the accounts as an item of expenditure in the Income and Expenditure Account (or Profit and Loss Account). It is represented in the Balance Sheet by a reduction in the value of assets from one year to the next.

The Computer Equipment

The computer equipment was purchased for £3,000 and is expected to last three years, by which time it will be virtually worthless. It was bought in April 2010 and the company is planning to replace it in April 2013.

So it reduces in value from £3,000 to zero over three years.
The depreciation is £1,000 per year.

The Van

The company van was bought for £14,000 and will be sold after three years' use. Its anticipated value when it is replaced is £2,000. It was bought in April 2010 and the company is planning to replace it in April 2013. It will have three years' useful life with the company and will reduce in value over that period by £12,000.

The cost to the company is a reduction in value of this asset (depreciation) of £4,000 per year.