WHAT IS SALVAGE VALUE?

Salvage value is the book value of an asset after all depreciation has been fully expensed.

The salvage value of an asset is based on what a company expects to receive in exchange for selling the asset at the end of its useful life.

An asset’s salvage value is an important component in the calculation of a depreciation schedule.

Salvage value can be estimated for any asset that a company will be depreciating on its books over time.

Every company will have its standards for estimating salvage value. Some companies may always depreciate an asset to $0 because its salvage value is low.

In general, the salvage value is important because it will be the carrying value of the asset on a company's books after depreciation has been fully expensed.

It is based on the value a company expects to receive from the sale of the asset at the end of its useful life.

In some cases, salvage value may just be a value the company believes it can obtain by selling a depreciated, inoperable asset for parts.

Depreciation and Salvage Value Assumptions

Companies take into consideration the matching principle when making assumptions for asset depreciation and salvage value.

The matching principle is an accrual accounting concept that requires a company to recognize expenses in the same period as the related revenues are earned.

If a company expects that an asset will contribute to revenue for a long period, it will have a long, useful life.

If a company is not sure of an asset's useful life, it may estimate a lower number of years and a higher salvage value to carry the asset on its books after full depreciation or sell the asset at its salvage value.

If a company wants to front-load depreciation expenses, it can use an accelerated depreciation method that deducts more depreciation expenses upfront.

Many companies use a salvage value of $0 because they believe that an asset’s utilization has fully matched its expense recognition with revenues over its useful life.

Depreciation Methods

There are five primary methods of depreciation financial accountants can choose from:

- Straight-Line Depreciation
- Declining Balance
- Double-Declining Balance
- Sum-of-Years Digits
- Units of Production

Straight-Line Depreciation

Straight-line depreciation is generally the most basic depreciation method. It includes equal depreciation expenses each year throughout the entire useful life until the entire asset is depreciated to its salvage value.

For example, a company buys a machine for $5,000. The company decides on a salvage value of $1,000 and a useful life of five years.

Based on these assumptions, the annual depreciation using the straight-line method is ($5,000 cost - $1,000 salvage value) / 5 years or $800 per year. This results in a depreciation percentage of 20% ($800/$4,000).

Declining Balance

The declining balance method is an accelerated depreciation method. This method depreciates the machine at its straight-line depreciation percentage times its remaining depreciable amount each year.

Because an asset's carrying value is higher in earlier years, the same percentage causes a larger depreciation expense amount in earlier years, declining each year.

For example, a machine costs $5,000, has a salvage value of $1,000, a 5-year life, and is depreciated at 20% each year, so the expense is $800 in the first year ($4,000 depreciable amount * 20%), $640 in the second year (($4,000 - $800) * 20%), and so on.

Double-Declining Balance

The double-declining balance (DDB) method uses a depreciation rate that is twice the rate of straight-line depreciation.

In the previous example, the depreciation percentage is 20%. Therefore, the DDB method would record depreciation expenses at (20% x 2) or 40% of the remaining depreciable amount per year.

Sum-of-Years Digits

This method creates a fraction for depreciation calculations.

Using the previous example, if the useful life is five years the denominator is 5+4+3+2+1=15.
 The numerator is the number of years left in the asset's useful life. The depreciation expense fraction for each of the five years is then 5/15, 4/15, 3/15, 2/15, and 1/15. Each fraction is multiplied times the total depreciable amount.

15=5+4+3+2+1			
Year 1	4000	5/15	1333.33
Year 2	4000	4/15	1066.67
Year 3	4000	3/15	800.00
Year 4	4000	2/15	533.33
Year 5	4000	1/15	266.67
			4000

Units of Production

This method requires an estimate of the total units an asset will produce over its useful life.

Depreciation expense is then calculated per year based on the number of units produced.

This method also calculates depreciation expenses based on the depreciable amount.

Formula and Calculation of Salvage Value

To estimate salvage value, a company may use the percentage of the original cost method.

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This method assumes that the salvage value is a percentage of the asset's original cost. To calculate the salvage value using this method, multiply the asset's original cost by the salvage value percentage.

Percentage of cost method = Original Cost * Salvage value percentage

Companies can also get an appraisal of the asset by reaching out to an independent, third-party appraiser.

This method involves obtaining an independent report of the asset's value at the end of its useful life. This may also be done by using industry-specific data to estimate the asset's value.

Companies can also use comparable data with existing assets they own, especially if these assets are normally used during the course of business. For example, consider a delivery company that frequently turns over its delivery trucks. That company may have the best sense of data based on their prior use of trucks.

Example of Salvage Value

Imagine a situation where a company acquires a fleet of vehicles. The company pays $250,000 for eight commuter vans it will use to deliver goods across town.

If the company estimates that the entire fleet would be worthless at the end of its useful life, the salvage value would be $0, and the company would depreciate the full $250,000.

Let's say the company assumes each vehicle will have a salvage value of $5,000. This means that of the $250,000 the company paid, the company expects to recover $40,000 at the end of its useful life.

To appropriately depreciate these assets, the company would depreciate the net of the cost and salvage value over the useful life of the assets. The total amount to be depreciated would be $210,000 ($250,000 less $40,000).

If the assets have a useful life of seven years, the company would depreciate the assets by $30,000 each year.

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