CHAPTER 13

DEPRECIATION

- **Meaning**

Depreciation means reduction in the value of fixed asset due to: normal wear and tear associated with continuous use of the asset passage of time (even though the asset is not put to use due to weather, rains, etc.)

- **Concept of Depreciation**

Purchase of fixed asset is considered as a capital expenditure and not an expense as its benefits can be availed over a period of time. Consequently, the cost of the asset is spread over the period of its useful life and due to continuous use of the fixed asset or with the passage of time, the value of the asset decreases. This reduction in the cost of the fixed asset is termed as depreciation.

According to the Matching Concept, depreciation is considered as an expense only to the extent of the decrease in the value of the asset during an accounting period. In other words, it refers to value of fixed asset consumed in the production process during an accounting period.

- **Depletion**

It refers to reduction in availability of natural resources due to extraction, mining and quarrying. It helps to ascertain reduction in product reserves of natural resources. In other words, it refers to the amount of natural resources used up during an accounting period.

- **Amortization**

  It refers to writing-off the value of intangible assets like, copyright, patents, etc. over its useful life. It measures the amount of intangible assets used up during an accounting period.

- **Obsolescence**

  It refers to the loss in the capital value of the existing fixed assets that is not physically worn out, due to advancement and appreciation of technology, scientific innovations and inventions, change in fashion, adoption of cost efficient production techniques.

- **Causes of Depreciation**
  - Physical wear and tear
  - Passage of time
  - Expiration of legal rights
  - Possibility of obsolescence

- **Objectives for Charging depreciation**
  - Determining exact profit or loss
  - Presenting true or fair view of the financial statements

- **Factors/Basis for determining amount of depreciation:**
  - Original Cost of the Asset Estimated Scrap Value
  - Estimated Life of the Asset

- **Methods of Providing/Charging Depreciation**

  There are several methods of charging depreciation but the popular methods are:
  - Fixed Installment Method
  - Diminishing Balance Method

❖ Formulas for Calculating Depreciation

- ***Fixed Installment Method/ Straight Line Method/ Original Cost Method***

  Formula:

  $$\text{Depreciation (p.a.)} = \frac{\text{Original cost} - \text{Scrap Value}}{\text{Estimate Life (in years)}}$$

  Or,

  $$\text{Depreciation (p.a.)} = \left(\text{Original Cost} - \text{Scrap Value}\right) \times \frac{\text{Rate of Depreciation}}{100}$$

  $$\begin{aligned}\text{Original Cost of the Asset} = {} & \text{Purchase Price of the Asset} \\ & + \text{Expenses Incurred Before installation of the Asset} \\ & \left(\text{freight and installation charges}\right)\end{aligned}$$

  Suitability: This method of charging depreciation is most suitable for those assets which have minimum repairs and renewals costs and comparatively short life, for example lease, copyrights, patents, etc.

- ***Diminishing Balance Method/ Reducing Balance Method/Book Value Method***

  Formula:

  $$\text{Depreciation (p.a.)} = \left(\text{Opening Balance/ Book Value of Asset}\right) \times \frac{\text{Rate of Depreciation}}{100}$$

  $$\text{Rate of Depreciation (p.a.)} = \left(1 - \sqrt[n]{\frac{S}{C}}\right) \times 100$$

  S represents scrap value of the asset

  C represents cost of the asset

  n represents the estimated life of asset in years

***Suitability*:** This method of charging depreciation is suitable for those assets which have comparatively long life and need higher repairs cost in the later period of its life. The value of these assets does not reduce to zero or nil.

❖ **Methods of Recording Depreciation/Accounting Treatment of Depreciation**

There are two ways of recording depreciation in the books of accounts.

- Depreciation is deducted from (credited to) the Asset Account/***without maintaining Provision for Depreciation Account.***
- Depreciation is not deducted from (credited to) Asset Account/ ***maintaining Provision for Depreciation Account.***

Journal Entries

Without Maintaining Provision for Depreciation Account	**Maintaining Provision for Depreciation Account**
Asset A/c Dr. To Cash/Bank/Creditors A/c (Asset purchased)	Asset A/c Dr. To Cash/Bank/Creditors A/c (Asset purchased)
Depreciation A/c Dr. To Asset A/c (Depreciation charged)	Depreciation A/c Dr. To Provision for Depreciation/ Accumulated depreciation A/c (Depreciation charged)
Profit and loss A/c Dr. To Depreciation A/c (Depreciation transferred to Profit and Loss Account)	Profit and loss A/c Dr. To Depreciation A/c (Depreciation transferred to Profit and Loss Account)

- **Asset Account when depreciation is deducted from (credited to) Asset Account**

Asset Account

Dr. **Cr.**

Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	Balance b/d (Opening balance/book value)				Depreciation A/c		
	Cash/Bank/Debtors A/c (Purchase of Asset)				Bank/Cash/Creditors A/c (Sale of Asset)		
	Profit and Loss A/c (Profit on sale of asset, if any)				Profit and Loss A/c (Loss on sale of Asset, if any)		
					Balance c/d (Closing balance)		

- **Asset Account when depreciation is *<u>not</u>* deducted from (credited to) Asset Account**

Asset Account

Dr. **Cr.**

Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	Balance b/d				Accumulated Dep./ Provision for Dep. A/c (Depreciation of asset being sold, transferred from Provision for Depreciation Account)		
	Bank/Cash/Debtors A/c (Purchase price *plus* expense on purchase of asset)				Bank/Cash/Creditors A/c (Sale of Asset)		

Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	Profit and Loss A/c(Profit on sale of asset, if any)				Profit and Loss A/c (Loss on sale of asset, if any) Balance c/d (Closing balance)		

Provision for Depreciation or Accumulated Depreciation Account

Dr. **Cr.**

Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	*Asset A/c (Accumulated depreciation on the asset sold, if it is transferred to the Asset Account) Balance c/d (*Balancing figure*)				Balance b/d Depreciation A/c (Depreciation charged on all assets during an accounting period)		