

DEPRECIATION

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CONCEPT

- Depreciation is the **cost of lost usefulness** or cost of diminution of service yield from a use of fixed assets.
- A permanent fall in the value of fixed assets arising through **wear and tear** from the use of those assets in business.

Definition

- “Depreciation is a measure of the wearing out, consumption or other loss of value of depreciation asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is predetermined.”

objectives

- To calculate proper **profits**.
- To show the asset at its **reasonable** value
- To maintain the original **monetary investment** of the asset intact.
- Provision of depreciation results in some **incidental** advantages also.
- To provide for **replacement** of an asset.
- Depreciation is permitted to be deducted from profits for **tax purposes**.

Causes of Depreciation

- **Internal causes:** wear and tear, disuse, maintenance, change in production, restriction of production, reduced demand, technical progress & depletion.
- **External causes:** obsolescence and effluxion of time

Factors in measurement of depreciation

- Total cost of asset
- Estimated useful service life or economic life
- The estimated turn-in (residual) value.

Methods of recording depreciation

- Straight line method or fixed installment
- Declining charge method or diminishing or WDV
- Sum of years digit method
- Inventory or revaluation method
- Annuity method
- Depreciation fund method
- Machine hour method/ Production unit method
- Depletion method

Straight line method or fixed installment

- Under this method, the same amount of depreciation is charged every year throughout the life of the asset.
- The formula = Total cost of acquisition - residual value
or

scrap value

Estimated life

$$r = R/C * 100;$$

r = depreciation rate

R = Amount of depreciation, C = Acquisition cost

- **Advantages of Straight line method:**
 - Simple, easy to understand and to apply
 - It provides uniform charge every year
 - It's calculated on original cost over the life time
- **Disadvantages:**
 - Depreciation is not related to the usage factor
 - It ignores the fact that in the later years of the life of the asset, efficiency of the asset declines.
 - Loss of interest on investment in the asset is not accounted for

Diminishing charge method or diminishing value method

- Some assets become quite old are normally used for down grading.
- Under this method depreciation is charged at fixed rate on the reducing balance every year.
- Formula $r = 1 - \sqrt[n]{S/C}$
- S = Residual value
- C = Cost of the asset

- **Advantages:**

- it's a simple method of providing depreciation as a fixed rate is applied on book-value or written down value of assets.
- This method is quite popular
- It provides uniform charge for charge for services of the asset through out the life

- **Disadvantages:**

- The method is slightly complicated
- If the asset has no residual valu, it is very difficult to calculate the rate.

Sum of years digit method

- Depreciation , where the amount of depreciation goes on decreasing in the coming years.
- Sum of the digits used in the life of assets.
- Depreciation = No. of years (including the current year) of the remaining life of the asset

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sum of all digits of the life of asset (in years)

scrap value)

(Original cost less