

Depreciation

Meaning : Depreciation means decline in the value of a fixed assets due to use, passage of time or obsolescence. As an accounting term, depreciation is that part of the cost of a fixed asset which has expired on account of its usage and/or lapse of time.

Features of Depreciation:

1. It is decline in the book value of fixed assets.
2. It includes loss of value due to effluxion of time, usage or obsolescence.
3. It is a continuing process.
4. It is an expired cost and hence must be deducted before calculating taxable profits.
5. It is a non-cash expense. It does not involve any cash outflow. It is the process of writing-off the capital expenditure already incurred.

Causes of Depreciation:

1. Wear and Tear due to Use or Passage of Time: Wear and tear means deterioration, and the consequent diminution in an assets value, arising from its use in business operations for earning revenue.

2. Expiration of Legal Rights: Certain categories of assets lose their value after the agreement governing their use in business comes to an end after the expiry of pre-determined period. Examples of such assets are patents, copyrights, leases, etc. whose utility to business is extinguished immediately upon the removal of legal backing to them.

3. Obsolescence: Obsolescence implies to an existing asset becoming out-of-date on account of the availability of better type of asset. It arises from such factors as:

- Technological changes;
- Improvements in production methods;
- Change in market demand for the product or service output of the asset;
- Legal or other description.

4. Abnormal Factors : Decline in the usefulness of the asset may be caused by abnormal factors such as accidents due to fire, earthquake, floods, etc. Accidental loss is permanent but not continuing or gradual.

Methods of Calculating Depreciation:

1. Straight Line Method: This is the earliest and one of the widely used methods of providing depreciation. This method is based on the assumption of equal usage of the asset over its entire useful life. It is also called fixed instalment method because the amount of depreciation remains constant from year to year over the useful life of the asset.

$$\text{Depreciation} = \frac{\text{Cost of asset} - \text{Estimated net residential value}}{\text{Estimated useful life of the asset}}$$

$$\text{Rate of Depreciation} = \frac{\text{Annual depreciation amount}}{\text{Acquisition cost}} \times 100$$

2. Written Down Value Method: Under this method, depreciation is charged on the book value of the asset.

Since book value keeps on reducing by the annual charge of depreciation, it is also known as Reducing Balance Method. This method involves the application of a pre-determined proportion/percentage of the book value of the asset at the beginning of every accounting period, so as to calculate the amount of depreciation.

Difference between Straight line Method and Written Down Method:

Basis of Difference	Straight line Method	Written Down Method
1. Basis of charging depreciation	Original cost	Book Value
2. Annual depreciation charge	Fixed (Constant) year	Declines year after year

3. Balance sheet treatment

In the balance sheet, the fixed asset continues to appear at its original cost on the asset side. The depreciation charged till that date appears in the provision for depreciation account, which is shown either on the “liabilities side” of the balance sheet or by way of deduction from the original cost of the asset concerned on the asset side of the balance sheet.

Disposal of Asset

Disposal of asset can take place either (a) at the end of its useful life or (b) during its useful life (due to obsolescence or any other abnormal factor).

If it is sold at the end of its useful life, the amount realised on account of the sale of asset as scrap should be credited to the asset account and the balance is transferred to profit and loss account. In this regard the following journal entries are recorded.

1. For sale of asset as scrap

Bank A/c	Dr.
To Asset A/c	

2. For transfer of balance in asset account

(a) In case of profit

Asset A/c	Dr.
To Profit and Loss A/c (b)	

In case of loss

Profit and Loss A/c	Dr.
To Asset A/c	

In case, however, the provision for depreciation account has been in use for recording the depreciation, then before passing the above entries transfer the balance of the provision for depreciation account to the asset account by recording the following journal entry:

Provision for depreciation A/c	Dr.
To Asset A/c	