11 Accountancy- Depreciation

Depreciation: 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 Obsolescence: Obsolescence implies to an existing asset becoming out-of-date on account of the availability of better type of asset.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.

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

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

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. Total charge against profit and loss account in respect of depreciation and repairs	Unequal year after year. It increases in later years.	Almost equal every year.
4. Recognition by income tax law	Not recognised	Recognised
5. Suitability	It is suitable for assets in which repair charges are less, the possibility of and obsolescence is low scrap value depends upon the time period involved.	It is suitable for assets, which are affected by technological changes and require more repair expenses with passage of time.

Methods of Recording Depreciation: In the books of account, there are two types of arrangements for recording depreciation on fixed assets:

- Charging depreciation to asset account or
- Creating Provision for depreciation/Accumulated depreciation account.

1. Charging Depreciation to Asset account: According to this arrangement, depreciation is deducted from the depreciable cost of the asset (credited to the asset account) and charged (or debited) to profit and loss account. Journal entries under this recording method are as follows:

1. For recording purchase of asset (only in the year of purchase)
Asset A/c Dr. (with the cost of asset including installation, freight, etc.)
To Bank/Vendor A/c

2. Following two entries are recorded at the end of every year
(a) For deducting depreciation amount from the cost of the asset.
Depreciation A/c Dr. (with the amount of depreciation)
To Asset A/c
(b) For charging depreciation to profit and loss account.
Profit & Loss A/c Dr. (with the amount of depreciation)
To Depreciation A/c

3. Balance Sheet Treatment
When this method is used, the fixed asset appears at its net book value (i.e., cost less depreciation charged till date) on the asset side of the balance sheet and not at its original cost (also known as historical cost).

2. Creating Provision for Depreciation Account/Accumulated Depreciation Account
This method is designed to accumulate the depreciation provided on an asset in a separate account generally called 'Provision for Depreciation' or 'Accumulated Depreciation' account.
The following journal entries are recorded under this method:
1. For recording purchase of asset (only in the year of purchase)
Asset A/c Dr. (with the cost of asset including installation, expenses etc.)
To Bank/Vendor A/c (cash/credit purchase)

2. Following two journal entries are recorded at the end of each year:
(a) For crediting depreciation amount to provision for depreciation account

Depreciation A/c Dr. (with the amount of depreciation)
To Provision for depreciation A/c
(b) For charging depreciation to profit and loss account
Profit & Loss A/c Dr. (with the amount of depreciation)
To Depreciation A/c

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