Depreciation

1. Introduction

A. Meaning

- Depreciation is a Process to spread the cost of asset as an expense Profit and Loss Account, over economic life of asset. It is a non-cash expense.

B. Objective / need for providing depreciation

- Ascertainment of correct cost of Production.
- Correct income measurement (P/L)
- Ascertainment of True and fair view of financial Position
- Ascertainment of correct Profit or loss on sale.
- meeting legal obligation.

C. Factors in the measurement of Depreciation

- cost of the asset
- useful life of the asset
- Residual value of Asset

Note:- Now our two main issues in this chapter is -
- Calculation of amount of Depreciation
- Accounting for Depreciation.

2. Calculation of Depreciation

- Followings are the methods to compute depreciation

I Straight Line Method

- It requires allocation of an equal amount to each Period. A fixed amount of the original cost is charged as depreciation each year in a manner as book value of asset reduces to zero or its residual value.

$$\boxed{\text{Depreciation} = \frac{\text{Cost of the asset} - \text{Residual value}}{\text{Estimated Economic Life}}}$$

II. Reducing Balance Method

- Under this method, instead of a fixed amount, a fixed rate on reduced balance of the asset is charged as depreciation every year. Amount of depreciation charged decreases every year over the life of asset.

- This method assumes that an asset should be depreciated more in the earlier years than later years because of the maximum loss of an asset occurs in the early years of use.

- Also we can see that amount of repairs and renewal is less in earlier years as compared in the later years which will get compensated by amount of depreciation.

III Sum of years Digit Method

- It is variation of the Reducing Balance method. In this case annual depreciation is calculated as follows -

$$= \frac{\text{Remaining Life of Asset (including present year)}}{\text{Total of all digits of life of asset}} \times [\text{Cost} - \text{Scrap value}]$$

↳ $\frac{n(n+1)}{2}$

IV Machine Hour Method

- The machine hour rate of depreciation is calculated after estimating the total number of hours that machine would work during its whole life.

- Amount of Depreciation would be -

$$= \frac{\text{Machine Hours during the year}}{\text{Total Estimated Machine Hours}} \times [\text{Cost} - \text{Scrap value}]$$

V Production Unit Method

- Under this method depreciation of asset is determined by comparing the annual Production with the estimated total Production during life of asset.

- Depreciation -

$$(\text{Cost} - \text{Scrap value}) \times \frac{\text{Production during the Period}}{\text{Estimated Total Production}}$$

VI. Depletion Method

- It is a technique used to allocate the cost of extracting natural resources such as timber, oil, minerals etc.

- Depreciation

$$= \text{Quantity Extracted during the year} \times \text{Rate/unit}$$

$$\text{Rate/unit} = \frac{\text{Cost of the asset}}{\text{Estimated quantity to be Extracted}}$$

3. Accounting For Depreciation

- There are two methods to recording depreciation in the books -
  - i) When no Provision for depreciation account is maintained
  - ii) When Provision for depreciation account is maintained.

I Without Provision for Depreciation

- Under this method depreciation directly charged to asset by debiting Depreciation A/c and crediting Asset A/c.

- At the end of the year Depreciation A/c is transferred to P/L A/c.
- Asset appears in Balance Sheet at Depreciated value.

II With Provision for Depreciation

- Under this method depreciation is not directly charged to Asset A/C
- Depreciation for the period is debited to Depreciation A/C and credited to Provision for depreciation A/C.
- Depreciation A/C will be transferred to P/L A/C. Asset appears at its original cost and Provision for depreciation is shown as deduction from asset A/C.

Note:- Under both the methods Depreciation upto the date of sale is to be charged in case of sale of asset.

Journal Entries

	Without Provision	With Provision
1. Purchase of Asset	Asset A/C -- Dr. To Bank A/C	Asset A/C -- Dr. To Bank A/C
2. Depreciation charged	Depreciation To Asset	Depreciation A/C -- Dr To Provision for Depreciation
3. Sale of Asset	Bank A/C -- Dr. Loss on sale A/c-Dr. B/F To Asset To Profit on sale B/F	Asset Disposal A/C To Asset A/C [cost of Asset] PFD A/C -- Dr. To Asset Disposal A/C [Depreciation charged till date, on asset sold] Bank A/C -- Dr. Loss on sale A/c-Dr. B/F To Asset Disposal A/C To Profit on sale A/C B/F

4. Change in method of Depreciation

- Method of Depreciation should be reviewed at least at the end of each financial year and if there has been a significant change in expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed.

- Change in method of depreciation is termed as change in Accounting Estimates, hence it is to be recognised prospectively [Jo ho gya so ho gya, current year se change kro.]

5. Revaluation of Asset

- After initial recognition of asset, if fair value of asset could be reliably measured then asset should be recorded at revalued figure.

- Depreciation should be charged at revalued figure during remaining life of asset.