DEPRECIATION

Depreciation refers to the decrease in the value of Fixed assets of the company over a time period due to use, Passage of time, and obsolescence.

it is the method to allocate the cost of an asset over its useful life.

Examples

Machines, Computers, Furniture, Vehicles, etc.

FEATURES OF DEPRECIATION

Non-Cash Expenses

Depreciation is a non-cash expense because it does not involve any outflow of cash.

Continuous Process

Depreciation is a continuous process of reduction in the value of the fixed assets, as every year depreciation is charged on the fixed assets.

Charge Against Profit

Depreciation is a charge against profit. It is done because actual profit can only be ascertained when depreciation is deducted from operational profit in the income statement.

Tax Benefit

It provides a tax benefit to the company, as the depreciation is adjusted to the profit before the payment of taxes

Decrease in the Book Value of Fixed Assets

CAUSES OF DEPRECIATION

The constant use of any asset by a business causes wear and tear, which causes a decrease in the value of those assets.

By passing of time

There are certain assets like leasehold property, patents, copy-right etc. that are acquired for a particular period. After the expiry of the period, their value ceases to exist.

By Obsolescence

New inventions, change in fashions and taste, market condition, Government policies etc. are the causes to discard the value of an asset.

FACTORS OF DEPRECIATION

- **Original Cost of the asset**
- **Estimated residual or scrap value**
- **Useful or economic life of asset**
- **Legal provisions**

METHODS OF CHARGING DEPRECIATION

STRAIGHT LINE METHOD/FIXED INSTALMENT METHOD

- This is a method of calculating the depreciation of an asset, which assumes that the asset will lose an equal amount of value each year.
- Depreciation is calculated every year on the depreciable value of asset.
- Amount of depreciation is constant every year.

Depreciation= Original Cost-Scrap Value / Life of Assets

Rate of depreciation= Amount of Depreciation / Cost of Assets X 100

WRITTEN DOWN VALUE/DIMINISHING VALUE METHOD

- Deprecation is calculated every year on written down value of asset. deprecation keeps on decreasing year after year.
- More depreciation tends to occur earlier in the asset's life. thus, the charge to the Profit & Loss account is higher in initial years as compared to the later years of life of such asset.

Annual Depreciation = Written Down Value X Percentage rate

ACCELERATED DEPRECIATION

- Accelerated depreciation is a depreciation method in which an asset loses book value at a faster (accelerated) rate than it would using traditional depreciation methods such as the straight-line method.
- Under accelerated depreciation, an asset faces greater deductions in its value in the earlier years than in the later years.

DOUBLE DECLINING BALANCE DEPRECIATION METHOD

Double-declining-balance depreciation results in a larger amount expensed in the earlier years as opposed to the later years of an asset's useful life.

STEPS FOR CALCULATIONS

- Calculate depreciation rate using straight line method
- Double the depreciation rate
- Calculate depreciation at doubled rate and
- Calculate the depreciation at diminishing value i.e., net book value for each year.

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SUM OF YEARS' DIGITS METHOD

- The sum of years' digits method is a form of accelerated depreciation that assumes that the productivity of the asset decreases with the passage of time.
- A fraction is computed by dividing the remaining useful life of the asset on a particular date by the sum of the year's digits. This fraction is applied to the depreciable cost of the asset to compute the depreciation expense for the period.

$$\text{Depreciation expense} = \frac{\text{Remaining useful life of the asset}}{\text{Sum of the years' digits}} \times \text{Depreciable cost}$$