

INTRODUCTION

To understand "what depreciation means" we have to expose the intricacies inherent in this word by way of the following detailed facts associated with the term. Every going concern acquires different types of assets broadly categorized into Fixed Assets and Current Assets. It is a fact that fixed assets are generally used for a longer period (i.e., more than one accounting period) and they are not for resale without using in the business activities. Despite the fact that fixed assets have longer life, they cannot be held perpetually in a concern. Fixed assets will have to lose their value over a period of time. At this stage one may say that the fall in value or quality of fixed assets may be connected with the term "Depreciation." But the word Depreciation denotes many more factors.

OBJECTIVE 1: DEFINITION OF DEPRECIATION

According to the Institute of Chartered Accountants of India, "Depreciation is a measure of the wearing out or other loss of value of a depreciable asset arising from use, time or obsolescence. Depreciation is allocated so as to charge a fair proportion of the cost in each accounting period during the Expected Useful Life of the Asset. Depreciation includes amortization". This is the Accounting Standard (AS) - 6.

According to the Institute of Chartered Accounts of England, "Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent on the amount of profit earned".

A careful analysis of the definition throws light on its character and extends its coverage by inclusion of some more terms like obsolescence, depletion and amortization.

OBJECTIVE 2: CHARACTERISTIC FEATURES OF "DEPRECIATION"

First, we shall look into its characteristic features:

- "Loss of value of depreciable asset" is an important phrase in the definition that explodes its character. Loss of value means fall in value - book value is reduced (its cost minus depreciation) - such a fall or reduction or decrease in value of fixed assets may be termed as "Depreciation".
- It is a fall or decrease in the book value of depreciable fixed assets.
- It is related to tangible fixed assets.
- The fall in book value of asset is due to constant use of such asset in business activities.
- The fall or loss of value or reduction in book value of tangible depreciable fixed assets is gradual, continuous and permanent.
- As the definition covers "depletion, obsolescence, amortization" - explanation of these terms will also throw some light - what depreciation means really.
- Depletion: This term is used in relation to natural resources like oil wells, deposits in mines, quarries and so on. It indicates exhaustion of natural resources. Such assets value will be reduced due to constant use and such reduction in the value of assets is referred to as "Depletion".
- Obsolescence: This term refers to the decline in economic value of assets. This may be due to invention of new techniques or equipment, market decline, change in fashion, inadequacy of existing fixed asset to meet increased demand and so on.
- Amortization: This term refers to loss of economic value of intangible assets such as patents, trademarks, goodwill and copyrights. Some of them have limited period of life. So they have to be written off and removed from the list of assets. The process of writing off of intangible assets is called amortization.

OBJECTIVE 3: ACCOUNTING CONCEPT OF DEPRECIATION

According to American Institute of Certified Public Accountants. "Depreciation Accounting is a system of accounting which aims to distribute cost or the basic value of tangible capital assets less salvage, if any,

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Procedure for Change
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over the estimated useful life of the unit (which may be group of assets) in a systematic and rational manner. It is a process of allocation and not of valuation.

- ✓ Depreciation accounting is the process of allocating the cost of the fixed tangible assets, less its salvage value over its serviceable life.
- Depreciation is an expense that is to be charged against the revenues of different years over the asset is to be used.
 - It is immaterial whether the business makes profit or loss.
 - The amount to be allocated each year should be systematic and rational.
 - Depreciation accounting does not refer to the decline in value of current assets resulting from obsolescence.
 - Depreciation is not the process of valuation, even if the market value of an asset increases, depreciation is to be recorded.

On the basis of above discussion (i.e., based on definition of depreciation and meaning of depreciation accounting) the following salient features come into light on "Depreciation."

OBJECTIVE 4: SALIENT FEATURES

- Depreciation is gradual but continues fall in the book value of fixed assets.
- Depreciation is caused due to depletion, obsolescence and amortization of fixed assets.
- Depreciation is related to tangible fixed assets.
- Depreciation is not connected with current assets.
- Depreciation in accounting is a process of allocating the cost (as an expense) in each of the accounting period in which the asset is used.
- Depreciation has no relationship with the market value of assets.
- Depreciation cost is not an exact amount, it is to be estimated.
- Depreciation is a charge against the profits.
- Total depreciation cannot exceed its depreciable value (cost – scrap value) or original cost in case the scrap value is nil.

OBJECTIVE 5: THE CAUSES OF DEPRECIATION

The causes for the decline in the usefulness of asset may be due to physical and functional factors.

5.1 Physical Features

Physical loss of an asset is due to

- (i) *Wear and Tear*: When the fixed assets are put into constant use, due to wear and tear, they may be rendered useless in course of time. Wear and tear may be due to friction, breakage and corrosion.
- (ii) *Passage of time*: Assets are affected when they are exposed to forces of nature – wind, rain, snow, heat of the sun, etc. – and with the passage of time the value of asset may get diminished even if they are not put in use.
- (iii) At times, natural calamities like earthquake, tsunami and factors like fire, flood and events of accident may cause the decline in the value of assets.

5.2 Functional Factors

- (i) *Inadequacy*: It may not be able to match the demand – if the demand expands, its value is declined.
- (ii) *Obsolescence*: New inventions and technological advancement may be the cause of the decline.
- (iii) *Depletion*: Exhaustion of natural resources.
- (iv) Expiry of legal rights relating to copyright, patent, leases and so on. will also be a factor.

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OBJECTIVE 6: NEED FOR DEPRECIATION

The need for charging a reasonable amount of depreciation arises for the following purpose or objectives.

1. **True Results of Operations:** It is necessary to charge the depreciation against income in each accounting period. Otherwise, the result of operations will not be fair and true.
2. **True and Fair View of Financial Position:** In the absence of depreciation charge, assets have to be shown at their original cost every year in the final accounts. In order to show true and fair final position, assets will have to be shown at cost less depreciation.
3. **Proper Cost of the Product:** Depreciation forms part of production like other expenses. In the absence of depreciation charge, cost records may not reveal true account of cost of production. To ascertain the proper cost of the product, it is imperative to provide for prescribed depreciation.
4. **Funds for Replacements of Assets:** A portion of profit is to be set aside in the form of depreciation every year which facilitates the task of replacement of assets at the end of its life. Without any additional financial burden, assets can be replaced in such accumulated depreciation provisions.
5. **Legal Requirements:** Legal requirements can be complied with, (as in case of companies) by way of charging depreciation on assets.
6. **Allocation of Cost of Fixed Assets:** The main objective of depreciation accounting is to allocate the cost of fixed asset to respective accounting periods which benefit from the use of the asset which can be achieved by charging depreciation.
7. **Impact on Tax-Liability:** Rate of depreciation is influenced by the tax-laws and thereby helps the tax liability to a certain extent.

OBJECTIVE 7: FACTORS AFFECTING AMOUNT OF DEPRECIATION

The amount of annual deprecation is based on the following factors:

1. **Historical Cost:** The cost includes all costs incurred in acquiring the depreciable fixed assets on its acquisition, installation and commissioning (e.g., invoice price, legal charges, freight, transport and so on.)
2. **Estimated Useful Life:** This depends on the intensity of use, standard of maintenance and the replacement policy of the management.
3. **Estimated Residual Value (Scrap Value) (Salvage Value):** The salvage value means the estimated amount that may be recovered on its sale or exchange for a new asset at the end of its useful service life.

OBJECTIVE 8: DEPRECIATION ON ASSETS

Following alternatives may be adopted to charge depreciation on assets purchased during the year:

Type	Period for which depreciation is to be charged
(A) If the rate of depreciation is expressed as ... % without the words of per annum (p.a.)	Depreciation is to be calculated for the full accounting period Depreciation is to be computed on the basis of time factor unless the examination problem requires otherwise
(i) When date of purchase or sale is not given	
(ii) When date of purchase or sale is given	

Type	Period for which depreciation is to be charged
(B) If the rate of depreciation ... % with the words p.a. is given (e.g. 12% p.a.)	
(i) If the date of the acquisition is given	(i) Depreciation is charged for the period beginning with the date acquisition and ending with the date of closing period
(ii) If the date of acquisition is NOT given	(ii) Assumption I: Assume that the asset was purchased in the beginning and charge the depreciation for a full year Assumption II: Assume that the asset was purchased in the middle of the year and charge the depreciation for half of the year Assumption III: Assume that the asset was purchased at the end of the accounting period and no depreciation is to be charged [Students are asked to put a note in any such case.]

OBJECTIVE 9: ACCOUNTING TREATMENT

Following are the two alternative methods of accounting entries for recording depreciation:

- By charging to asset account directly.
- By creating Provision for Depreciation/Accumulated Depreciation Account.

9.1 Method 1: By Charging to Asset Account Directly

This accounting procedure is applicable to all the methods of depreciation except Sinking Fund Method. Under this method of recording depreciation, it is directly credited to the "respective asset account" with the result that the respective asset account appears in the Balance Sheet at its book value or cost value less depreciation for the accounting period.

9.2 Method 2: By Creating Provision for Depreciation

Under this method, the asset account is not at all affected by the depreciation amount. Asset appears in the books (Ledger and Balance Sheet) at its original cost until sold or discarded.

The amount stands in the credit side of the Provision for Depreciation Account depicts the total amount of depreciation accumulated to date. When the asset is sold, that accumulated amount in the Provision for Depreciation Account is transferred to the respective asset account and closed.

Difference between these two methods of accounting:

Directly Charged to Asset A/c	Provision for Depreciation
(1) The asset is shown in the Balance Sheet at its cost or book value less depreciation relating to that accounting period.	(1) The asset always appears at its original cost in the Ledger and the Balance Sheet.
(2) Total amount of depreciation cannot be ascertained from a single Balance Sheet.	(2) Total amount of depreciation written off up to date can be ascertained even from the last single Balance Sheet.
(3) It is difficult to assess, whether the asset is new or old or when purchased, in the absence of any accounting information.	(3) It is very easy to find out the age of asset with the help of cost of asset and accumulated depreciation.

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