LESSON-14
DEPRECIATION

SUMMARY

If the expenditure on the fixed assets is deducted from the profit of any one year, it would be wrong. Since their benefit is enjoyed by the business for more than one years. The correct thing will be to distribute their cost over the years of their useful life to the business. The portion of the cost of fixed assets charged each year as expense is named as depreciation.

MEANING OF DEPRECIATION

Depreciation is an expense charged during a year for the reduction in the value of fixed assets, arising due to:

- Normal wear and tear out of its use and passage of time
- Obsolescence due to change in technology, fashion, taste and other market conditions

CAUSES OF DEPRECIATION

i) Normal wear and tear
ii) Obsolescence

OBJECTIVES OF CHARGING DEPRECIATION

- **To show the True Financial Position of the Business**
- **To retain funds in the business for replacement of the asset**

FACTORS AFFECTING THE DEPRECIATION

i) **Cost of Asset :** Cost of asset is the purchase price of the asset and includes all such expenses which are incurred before it is first put to use. For example expenses on loading, carriage, installation, transportation and unloading of the asset up to the point of its location, expense on its erection and assembly.

ii) **Useful Life of the Asset :** Useful life is the expected number of years for which the asset will remain in use.

iii) **Scrap Value :** Scrap value is the residual value at which the asset could be sold to scrap dealer *(Kabari)* after its useful life.

iv) **Depreciable value of asset :** Depreciable value is the cost of asset minus the scrap value.

METHOD OF CHARGING DEPRECIATION

1. Straight Line Method of Charging Depreciation

Depreciation of Each Year= Cost of Assets-Estimated Scrap Value/ Number of years of expected life

Merits of Straight Line Method

- **Simplicity**
- **Asset is completely Written Off**

Limitations of Straight Line Method

- **Difficulty in Computation**
- **Illogical**

2. Diminishing Balance Method

Under this method, as the value of asset goes on diminishing year after year, the amount of depreciation charged every year goes on declining. The amount of depreciation is calculated as a fixed percentage of the diminishing value of the asset shown in the books at the beginning of each year. Under this method the value of an asset never comes to zero.

Merits of Diminishing Balance Method

Equal Burden on Profit & Loss Account

Demerits of Diminishing Balance Method

Asset cannot be completely written off

Complexity

ASSET DISPOSAL ACCOUNT

If part of the asset is sold, it is appropriate to open a new account called as 'Assets Disposal Account'. In this case, method of recording the entries will depend on the fact whether :

- Provision for Depreciation A/c is not maintained.
- Provision for Depreciation A/c is maintained.

ACTIVITY

Ask your parents about the date of various fixed assets purchased by them like T.V., Fridge, Motorcycle, Car etc., with its useful life and then calculate the amount of depreciation to be charged on each asset.