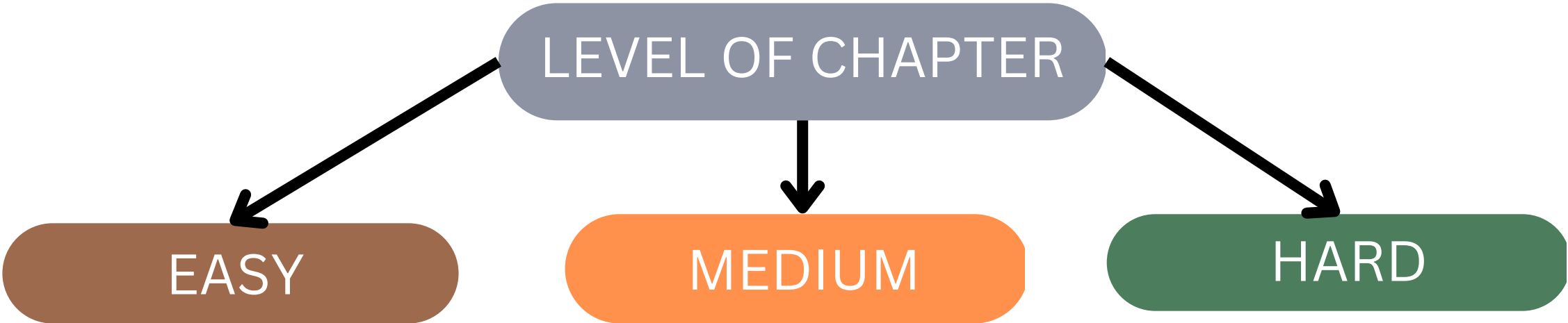


# DEPRECIATION ACCOUNTING

14





**(i) Meaning of Depreciation -**

Depreciation is the Allocation of NET COST of a PPE Over its USEFUL LIFE so that accounting principles are followed.

**(ii) PPE - PPE Stands For "Property Plant and Equipment"**

It Includes Items which are :-

- (a) Tangible in nature
- (b) Held for use in the business
- (c) expected to be used for more than 12 months.

Examples - Machinery, Furniture, Building etc.



**(iii) Net Cost :-** It is the net amount Paid / payable for Purchase / construction of a PPE .

It can be Calculated as :-

Basic Purchase Price	XXX
Less : Discounts / Rebate	(XXX)
= Net Purchase Price	XXX
Add: Non - Refundable Taxes	XXX
Add: Directly attributable cost to bring PPE to its Present Location and condition	XXX
Add: Cost of Dismantling	XXX
= COST OF PPE	XXX
Less: SCRAP VALUE	(XXX)
= NET COST OF PPE	XXX

NOTES:-

1. Examples of Directly Attributable Cost = Cost of employee benefits



- Cost of Site Preparation
- Delivery charges
- Installation and assembly cost
- Trial Run cost net of trial run proceeds
- Professional fee

2. Following will not be Included in Directly Attributable cost :-



- Inauguration Cost
- Advertisement/ Promotional cost
- Shifting Cost
- Staff Training Cost
- Administration and other general OH

3. Scrap Value is the recoverable portion of Cost Incurred , when assets remains of no use to the business. It is an estimated amount which can be affected by Revaluation. It is also known as Residual Value/ Salvage Value / Terminal Value / Fetch Value.

(iv) ESTIMATED USEFUL LIFE = It is an Estimation of the period for which PPE will be available for use .

Life can be given in 3 Ways :-

- (a) In Years
- (b) In Hours
- (c) In Units



(i) Straight Line Method :- As per this method , depreciation is calculated as :-

$$\frac{\text{Net Cost}}{\text{Estimated Useful Life}}$$

Under this method, amount of Depreciation remains same every year. It is also known as Original Cost Method / Fixed Installment method / Fixed Cost Method.

Also, Rate of Depreciation can be calculated as :-

$$\frac{\text{Annual Depreciation}}{\text{Cost [not excluding Scrap value]}} \times 100$$





(ii) **Written Down Value Method [WDV] :-** This method of depreciation is introduced to provide following advantages :-

- a) To stabilize the combined effect of Repairs and Depreciation on the P&L A/C Over the years so that variations in annual profits/losses is eliminated.
- b) This method is recognized by Tax Authorities.

As per this method, Depreciation is calculated at a Fixed percentage on the Opening WDV of the Assets . Under this method, depreciation goes on Decreasing every year .

One of the disadvantages of this method is that The COST is never Fully allocated . It is also known as Diminishing balance method, Reducing balance method, Reducing cost method .

The Rate of depreciation under WDV method can be calculated as :-

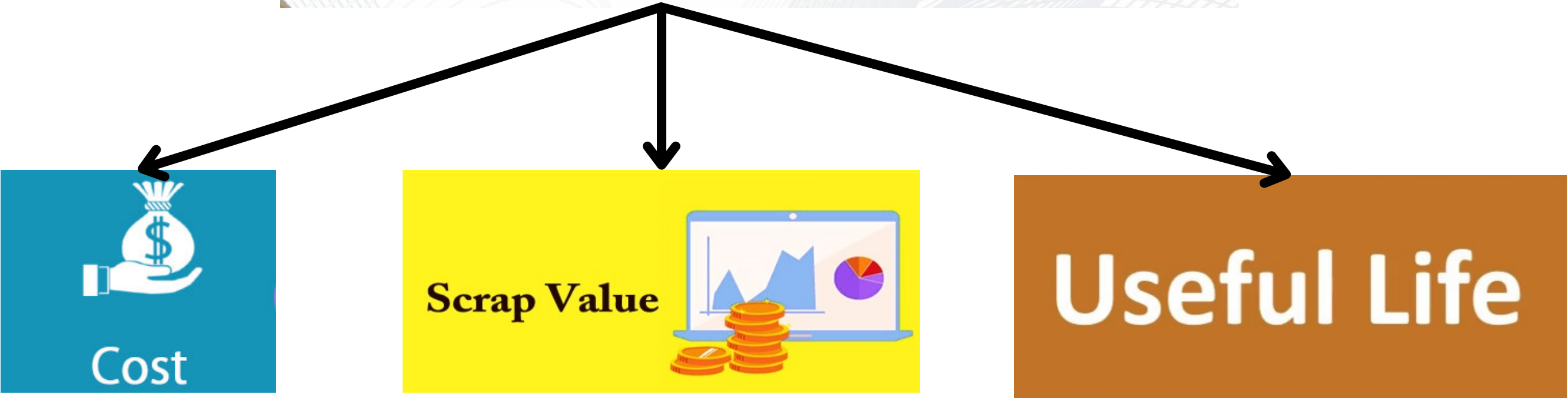
$$\frac{1 - \sqrt[n]{\text{Residual Value}}}{\text{Cost of Asset}} \times 100$$

where n = Useful life

**C. Factors Affecting Depreciation -**

There are Three factors that mainly affect the calcuation of depreciation . They are COST , SCRAP VALUE AND USEFUL LIFE . All of them together affect the calculation of depreciation . When we calculate depreciation by WDV method applying the Rate only to WDV, the life gets considered indirectly as it is used in the calculation of such rate .

**Factors Affecting the Amount of Depreciation**





**KASAM NO. 1 = REMEMBER TO CHARGE DEPRECIATION FROM 1ST DAY OF YEAR UPTO THE DATE OF SALE.**

**KASAM NO. 2 = DONT FORGET THIS ENTRY = P&L A/C Dr.**

**To depreciation A/C**

**KASAM NO.3 = P&L A/C will be Replaced by Statement of Profit or loss in case of companies.**

### **NOTES:-**

**1. Provision for dep. is also called Accumulated depreciation.**

**2. To calculate Profit or loss on sale of Assets :-**

**Written down value of asset on date of sale XXX**

**Less:- Sale Price (XXX)**

**= LOSS XXX**

**Sale Price XXX**

**Less:- WDV of asset on date of sale (XXX)**

**= Profit XXX**

**To calculate WDV on date of sale , Depreciation from date of purchase till date of sale should be deducted from Cost of Asset. It can also be picked from Asset A/C if value is readily available.**

**3. Asset disposal A/C gets activated at time of sale only.**

### **E - Change in Method of depreciation:-**

**As per consistency principle of accounting , an accounting policy or method once adopted should be followed consistently over the future years. But in case , if the changed method /policy can better reflect the true and fair financial position of the business , change should take place . Also as per AS-1 , Change in accounting policies/methods should be disclosed along with their effects on financial statements of current year as well as future years.**

**Adopting a different method of depreciation is a change in accounting policy adopted . Therefore as per AS-1, its effects needs to be calculated and disclosed .**

**Note :- The change in method of depreciation can take place retrospectively as well.**

### **F. Revision of Life :-**

**The scrap value and Estimated useful life of the asset must be reviewed every year.**

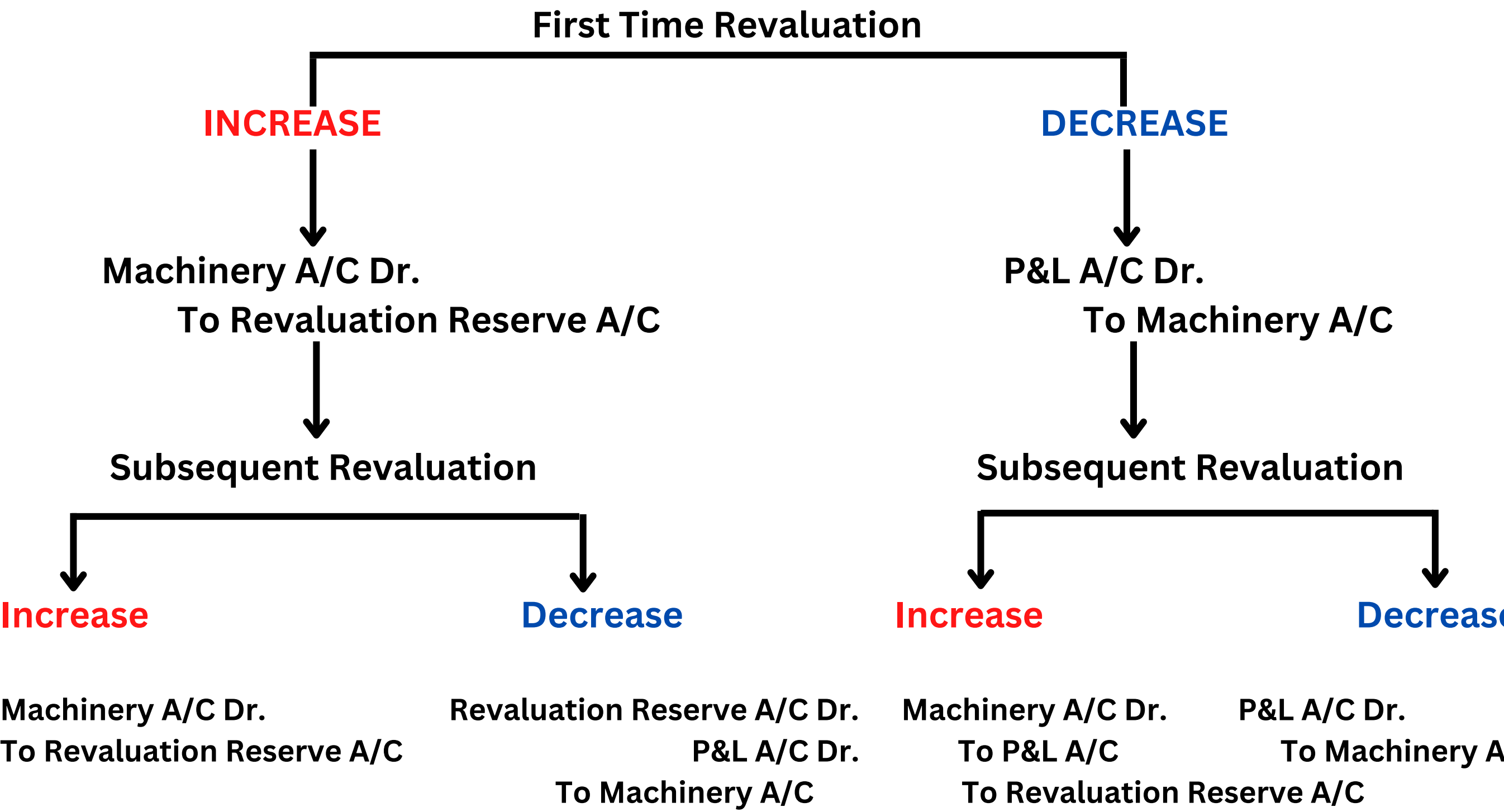
**As per the need, the remaining useful life can be reassessed as well.**

**In such a case, the depreciation for the remaining period is calculated on the basis of revised useful life.**



G Revaluation of PPE:-

The book value of the PPE should be Revalued at regular intervals depending upon the flexibility in the fair value of the PPE . If it keeps on changing frequently , Revaluation must be done once every year. But if changes are not that frequent, Revaluation can be done once in every 3-5 years.



H Other Methods of Depreciation

(i) Sum of years of digits methods :- The advantages of this method of depreciation are same as that of WDV . One superiority is that under this method , the cost can be allocated to zero. Hence this method overcomes the disadvantage of WDV Method. Here,  $Depreciation = \frac{\text{No. of years of remaining life of asset [inc. current year]}}{\text{Total of all digits of life of the asset [ in years ]}} \times \text{Depreciable amount}$

(ii) Machine hour Rate method :- Depreciation is calculated on the basis of no. of hours machine operated during the year divided by total useful hours of the machinery, multiplying the coming factor with the NET COST [Depreciable amount].

(iii) Production unit method :-  
 $Depreciation = \frac{\text{Depreciable amount} \times \text{Production during the period}}{\text{Estimated Total Production}}$

(iv) Depletion method:- This method is used in case of Mines , quarries etc.  
 $Depreciation = \text{Quantity extracted} \times \text{rate per unit/-}$   
 $Rate = \frac{\text{Cost of Asset}}{\text{Estimated quantity of product available for extraction}}$

### **I Objectives of providing depreciation :-**

- (a) Correct income measurement.**
- (b) True position statement i.e. Machinery is shown at reduced value .**
- (c) Funds for Replacement.**
- (d) Ascertainment of true cost of production.**

### **SOME IMPORTANT POINTS :-**

- 1. Depreciation is a non cash expense.**
- 2. Depreciation is derived from the word "Depretium".**
- 3. Depreciation is a nominal account.**
- 4. Going concern assumption allows depreciation.**
- 5. Depreciation can be provided on component basis.**
- 6. No depreciation is provided on land because land has infinite life.**
- 7. Software is intangible asset.**
- 8. Depreciation is also charged in case of loss.**
- 9. Depreciation is an amortized expenditure.**
- 10. Some causes of depreciation are wear and tear, lapse of time, obsolescence, exhaustion, non-use, market trend, maintenance**