BCM-102

FINANCIAL ACCOUNTING

UNIT-9 DEPRECIATION

(B. COM. FIRST YEAR)

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Depreciation

- On the basis of Fundamental Accounting Concept of Going Concern, assets are classified as Fixed Assets and Current Assets. Fixed assets are used in the business to derive benefits for more than one accounting period. Periodic profit is measured by charging cost against periodic revenue as per matching concept. Since fixed assets are used to generate periodic revenue, an appropriate proportion of the cost of fixed assets, which is believed to be used or expired for generation of periodic revenue, needs to be charged as cost. Such an appropriate proportion of the cost of fixed assets is termed as *Depreciation*.
- Generally, the term 'depreciation' is used to denote decrease in value but in accounting, this term is used to denote decrease in the book value of a fixed asset. Depreciation is the permanent and continuous decrease in the book value of a fixed asset due to use, passage of time, obsolescence, expiration of legal rights or any other cause.

Characteristics of Depreciation

- (a) It is related to *Depreciable fixed assets* only.
- (b) It is a fall in the *book value* of depreciable fixed asset.
- (c) The fall in the book value of an asset is *due to* the use of the asset in business operations, effluxion of time, obsolescence, expiration of legal rights or any other cause.
- (d) It is a *permanent decrease* in the book value of an asset.
- (e) It is a *continuous decrease* in the book value of an asset.

Reasons of Depreciation

- **(a) Wear and Tear:** When the fixed assets are put to use, the value of such assets may decrease due to usage. Such decrease in the value of assets is said to be due to physical wear and tear.
- **(b) Time:** When the assets are exposed to the forces of nature like weather, winds, rains, etc. the value of such assets may decrease even if they are not put to any use.
- **(c) Changes in economic environment:** The value of an asset may decrease due to decrease in the demand of the asset. The demand of the asset may get down due to technological changes, changes in the habits of consumers etc.
- **(d) Expiration of legal rights:** When the use of an asset (e.g., patents, leases) is governed by the time bound arrangement, the value of such assets may decrease with the passage of time.

Why We Charge Depreciation?

- **To ascertain true results of operations :** For proper matching of costs with revenues, it is necessary to charge the depreciation (cost) against income (revenue) in each accounting period. Unless the depreciation is charged against income, the result of operations would stand overstated. Resultby, the Income Statement would fail to present a true and fair picture of the profits and losses of an accounting entity.
- **To provide true and fair picture of the financial position of business:** For presenting a true and fair picture of the financial position, it is necessary to charge the depreciation. If the depreciation is not charged, the unexpired cost of the asset concerned would be overstated. Resultby, the Balance Sheet would not present a true and fair picture of the financial position of an accounting entity.
- **To ascertain the true cost of production:** For ascertaining the cost of production, it is necessary to charge depreciation as a component of cost of production. If the depreciation on fixed assets is not charged, the cost records, would not present a true and fair view of the cost of production.
- **To comply with legal requirements:** In India, in case of companies, it is compulsory to charge depreciation on fixed assets before it declares dividend as per the provisions of Sec. 205(1) of The Companies Act, 1956.

- **To use it as a source of fund :** A portion of profits is kept aside in the form of depreciation and accumulated each year to provide a definite amount at a certain future date for the specific purpose of replacement of the asset at the end of its useful life.

Factors Affecting the Amount of Depreciation

- Historical cost of a depreciable asset implies the cost incurred on its acquisition, installation, commissioning and for additions to or improvements thereof which are of capital nature.
- Expected useful life of a depreciable asset implies either the period over which a depreciable asset is expected to be used by the enterprise or the number of production or similar units expected to be obtained from the use of the asset by the enterprise.
- Estimated residual value of a depreciable asset implies the value expected to be realised on its sale or exchange on the expiry of its useful life.

Ways for Charging Depreciation

- **Charging it to Asset account:** Under this method of recording depreciation, depreciation is directly credited to the 'Respective Asset Account' and as a result, the Respective Asset Account appears at its book value (i.e. Original Cost *less* depreciation till date).

	Journal Entries in the Books of LK Limited			
Date	**Particulars**	**L.F.**	**Amounts**	**Amounts**
For the Purchase of Assets	Assets A/c Dr		XXX	
	To Cash A/c			XXX
	(Being Assets purchased.)			
For Providing Depreciation	Depreciation A/c Dr		XXX	
	To Assets A/c			XXX
	(Being Assets depreciated.)			
For transferring Dep-reciation to P/L A/c	P/L A/c Dr		XXX	
	To Depreciation A/c			XXX
	(Being Dep. trd. To P/L A/c.)			
in case asset is sold	Bank A/c Dr		XXX	
	P/L A/c Dr (Loss)		XXX	
	To Assets A/c			XXX
	To P/L A/c (Profit)			XXX
	(Being assets sold)			

Ways for Charging Depreciation

- **By Creating Provision for Depreciation/ Accumulated Depreciation Account :** In this way Provision for Depreciation A/c is created from P/L Account for which following journal entries are recorded :

Date	Particulars	L.F.	Amounts	Amounts
For Providing Depreciation	Depreciation A/c Dr		XXX	
	To Provision for Depreciation A/c			XXX
	(Being Depreciation Charged.)			
For Closure of Depreciation A/c	Profit & Loss A/c Dr		XXX	
	To Depreciation A/c			XXX
	(Being Depreciation trd.to P/L A/c.)			

Methods of Allocating Depreciation

- **1. Straight Line Method' of Depreciation (SLM) :** Under the straight line method, a fixed and equal amount in the form of depreciation, according to a fixed percentage on the original cost, is written off during each accounting period over the expected useful life of the asset.
- Ways to Calculate the Rate of Depreciation under SLM:
- The amount and rate of depreciation is calculated as under:

$$\text{Amount of } Depreciation = \frac{\text{Cost of the Machine} - \text{Salvage Value}}{\text{Life of the Plant}}$$

$$Rate\ of\ Depreciation = \frac{\text{Amount of Depreciation}}{\text{Cost of Assets}} \times 100$$

- **2. Diminishing Balance Method/ Written Down Value Method (WDV Method) :**
- **Written Down Value Method' of Depreciation (WDV):** Under this method, depreciation is calculated at a fixed percentage upon the original cost (in the first year) and written down value, (in subsequent years) of an asset. Asset is written off during each accounting period over the expected useful life of the asset. Under this method, the rate of depreciation remains constant year after year whereas the amount of depreciation goes on decreasing.
- **Method for Calculation of Rate of Depreciation under WDV Method:**
- The rate of depreciation is calculated by the following formulae:

$$Rate\ of\ Depreciation:\ R = \left[1 - \sqrt[n]{\frac{S}{C}}\right] \times 100$$

Where R = Rate of Depreciation (in %),

n = Useful life of the asset (in years)

S = Scrap value at the end of useful life of the asset

C = Cost of the asset

Change in the Method of Depreciation

- As per the revised Accounting Standard- 6 issued by ICAI, the depreciation method selected should be applied consistently, to provide comparability of the results of the operations of the surprise from period to period. A change from one method of providing depreciation to another would be made only if, the adoption of the new method is required by statute or for compliance with an Accounting Standard or, if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.

- When such a change at the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective re-computation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed case the change in the method results in deficiency in depreciation in respect of past year the deficiency should be charged in the statement of profit and loss.

Summary

- The term ‘depreciation’ is used to denote decrease in value but in accounting, this term is used to denote decrease in the book value of a fixed asset. Depreciation is the permanent and continuous decrease in the book value of a fixed asset due to continuous use, obsolescence, expiration of legal rights or any other cause. There are many methods for charging depreciation like Straight Line Method (S.L.M.) , Written Down Value Method (W.D.V. Method), Sum of the Years Digit Method, Annuity Method etc but out of all these methods W.D.V. and S.L.M. are the most popular methods of depreciation. For depreciation, Accounting Standard - 6 (AS-6) issued by The Institute of Chartered Accountants of India is applicable.

References

- SILM developed by Uttarakhand Open University for BCM-102 (Financial Accounting), Year 2017, ISBN: 978-93-85740-44-2