DEPRECIATION

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Meaning of Depreciation

A business enterprise acquires different types of fixed assets depending upon its requirements and financial conditions. Fixed assets have a long life and are held for use in the business for production of goods and services. Whenever an asset is used in business its value gets reduced and sooner or later the asset becomes useless. Depreciation is a permanent, continuous and gradual shrinkage in the book value of a fixed asset. It is the fall in the quality or value of a fixed asset through physical wear and tear due to use or passage of time or from any other cause. Depreciation takes place irrespective of regular repairs and maintenance. As the asset is used for business purpose, the annual loss in the value of the asset is like any other expenditure. Hence, the cost of fixed assets has to be written off over its useful economic life as a loss.

Thus, depreciation is a process of allocating the cost of a fixed asset over its estimated useful life in a rational and systematic manner.

Definition of Depreciation

The Institute of Charted Accountants of India has defined depreciation as “a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.”

Characteristics of Depreciation

(i) Depreciation refers to a permanent, continuous and gradual decrease in the utility value of a fixed asset and it continues till the end of the useful life of the asset.

(ii) Depreciation is a charge against profit (i.e. revenue earned) for a particular accounting period.

(iii) Depreciation is always computed in a systematic and rational manner since it is not a sudden loss.

(iv) Depreciation is a process of allocation of expired cost and not of valuation of fixed assets.

(v) Whatever method for calculating depreciation is followed, the exact amount of depreciation can never be calculated, and it can only be estimated.

(vi) Depreciation is caused due to physical factors and functional factors.

(vii) The fundamental objectives of depreciation are - (a) to maintain the nominal capital invested in fixed assets, and (b) to allocate the expired portion of the cost of fixed assets over a number of accounting periods.

(viii) Depreciation is must, i.e. it always takes place whether the asset is carefully handled or neglected.

(ix) If the market value of a fixed asset is fluctuating, the same does not affect the amount of depreciation so made on the respective assets.

(x) Depreciation is calculated in respect of fixed assets only, i.e. plant, machinery, furniture etc.

Causes of Depreciation

- *Physical Wear and Tear Resulting from Use*
- *Physical Deterioration Resulting from Atmospheric Exposure*
- *Passage of Time*
- *Depletion*
- *Obsolescence*

Objectives of Providing Depreciation

- (i**) *To ascertain the correct profit*: *When a particular asset is used for earning the income of the business,*** the depreciation in the value of assets should be deducted from the income in order to calculate the correct and real profit of the business.
- (ii) ***To present true financial position***: *In order to show the true financial position of the business in the* balance sheet, it is necessary that assets must be shown at their true values after deducting reasonable depreciation. If depreciation is not provided, the assets will be overstated in the financial statements and it will be against sound business principles.
- (iii) ***To make provision for replacement of assets***: *Since depreciation is a non-cash expense, the amount* charged can be kept separately and utilised for the replacement of the fixed asset after the expiry of the useful life of the asset.
- (iv) ***To ascertain the proper cost of the product***: *In order to ascertain the cost of production, it is necessary* to charge depreciation as an item of cost of production.
- (v) To maintain the capital invested in the cost of the asset intact in the business so that it can be reinvested in profit earning process.
- (vi) **To derive maximum tax benefit**.
- (vii) ***To meet the legal requirements***: *In the case of joint stock companies, it is necessary to charge* depreciation on fixed assets before declaring dividends.

Factors in Measurement of Depreciation

The factors which affect measurement of depreciation are given below:

(i) The original cost of asset: The cost includes all cost incurred in acquiring the asset, i.e. purchase price including transportation and installation costs, if any.

(ii) The additions, if any, made to the assets during the year taking into consideration the date on which these additions were made.

(iii) The estimated useful life of the asset.

(iv) The scrap or the residual value of the asset.

(v) Obsolescence, i.e., the chance of the asset going out of fashion.

(vi) The working hours of the asset concerned.

(vii) The repairs and renewals.

(viii) The skill of the operators who handle the asset.

(ix) The legal provisions or other restrictions relating to depreciation.

METHODS OF PROVIDING DEPRECIATION

- **UNIFORM CHARGE METHODS**

  FIXED INSTALMENT METHOD

  ANNUITY METHOD

  DEPRECIATION FUND METHOD

  INSURANCE POLICY METHOD

- **DECLINING CHARGE METHODS**

  DIMINISHING BALANCE METHOD

  SUM OF YEARS DIGITS METHOD

  DOUBLE DECLINING METHOD

- **OTHER METHODS**

  GROUP DEPRECIATION METHOD

  INVENTORY SYSTEM (VALUATION)

  DEPLETION METHOD

  MACHINE HOUR RATE METHOD

THANKS