FINANCIAL ACCOUNTING (LECTURE # 17)

DEPRECIATION

Depreciation is a systematic allocation of the cost of a depreciable asset to expense over its useful life. It is a process of charging a fixed asset to profit & loss account.
Fixed Assets are those assets, which are:

- Of long life
- To be used in the business
- Not bought with the main purpose of resale.

When an expense is incurred, it is charged to profit & loss account of the same accounting period in which it has incurred. Fixed assets are used for longer period of time. Now, the question is how to charge a fixed asset to profit & loss account. For this purpose, estimated life of the asset is determined. Estimated useful life is the number of years in which a fixed asset is expected to be used efficiently. It is the life for which a machine is estimated to provide more benefit than the cost to run it. Then, total cost of the asset is divided by total number of estimated years. The value, so determined, is called 'depreciation for the year' and is charged to profit & loss account. The same amount is deducted from total cost of fixed asset, in which depreciation is charged. The net amount (after deducting depreciation) is called 'Written Down Value'.
WDV = Cost of fixed asset – Accumulated Depreciation

Depreciation is accumulated over the years and is called accumulated depreciation.

GROUPINGS OF FIXED ASSETS

Major groups of Fixed Assets:

- Land
- Building
- Plant and Machinery
- Furniture and Fixtures
- Office Equipment
- Vehicles

No depreciation is charged for 'Land'. In case of 'Leased Asset/Lease Hold Land' the amount paid for it is charged over the life of the lease and is called Amortization.

RECORDING OF JOURNAL ENTRIES

Purchase of fixed asset:

Debit:	Relevant asset account	
Credit:		Cash, Bank or Payable Account

For recording of depreciation, following two heads of accounts are used:

- Depreciation Expense Account
- Accumulated Depreciation Account

Depreciation expense account contains the depreciation of the current year. Accumulated depreciation contains the depreciation of the asset from the financial year in which it was bought. Depreciation of the following years in which asset was used, is added up in this account. In other words, this head of account shows the cost of usage of the asset up to the current year. Depreciation account is charged to profit & loss account under the heading of Administrative Expenses. In the balance sheet, fixed assets are presented at written down value. i-e. WDV = Actual cost of fixed asset – Accumulated Depreciation.

Journal entry for the depreciation is given below:

Debit: Depreciation Account
Credit: Accumulated Depreciation Account

PRESENTATION OF DEPRECIATION

Charging depreciation to any head in profit & loss account depends upon the nature of work performed by the asset. Consider an organization has purchased computers. If computers are being used by the management, this means that administrative work is done by computers. So, depreciation of the computers will be charged to Administrative Expenses. On the other hand, if machines working in the factory are computerized. The value of depreciation of the computer attached with the machines will be charged to cost of goods sold. The reason being, the computers are the part of manufacturing process & the depreciation will be charged to the cost of production. Again consider the selling department of the business is very large. Depreciation of computers used in selling department will be charged to selling expenses.

You can see that computer is a single asset and its depreciation is charged in three different heads depending upon the nature of work done by the computer.

METHODS OF CALCULATING DEPRECIATION

There are several methods of calculating depreciation. At this stage, we will discuss only two of them namely:

- Straight line method
- Reducing balance method

STRAIGHT LINE METHOD

Under this method, a fixed amount is calculated by a formula. That fixed amount is charged every year irrespective of the written down value of the asset. The formula for calculating the depreciation is given below:

Depreciation = (cost – Residual value) / Expected useful life of the asset

Residual value is the cost of the asset after the expiry of its useful life.
Under this method, at the expiry of asset's useful life, its written down value will become zero. Consider the following example:

Cost of an asset:	Rs. 120,000
Residual value:	Rs. 20,000
Expected life:	Rs. 5 years

Calculate depreciation and the written down value of the asset for five years.

SOLUTION

Depreciation = (120,000 – 20,000) / 5 = Rs. 20,000

Particulars	Depreciation (Rs)	Written Down Value (Rs.)
Depreciable cost		100,000
Dep. Of the 1st year	(20,000)	80,000
Dep. Of the 2nd year	(20,000)	60,000
Dep. Of the 3rd year	(20,000)	40,000
Dep. Of the 4th year	(20,000)	20,000
Dep. Of the 5th year	(20,000)	0

REDUCING BALANCE METHOD

Under this method, depreciation is calculated on written down value. In the first year, depreciation is calculated on cost. Afterwards written down value is calculated(cost – accumulated depreciation) and depreciation is charged on that value. In this method, the value of asset never becomes zero. Consider the following example:

Cost of an asset:	Rs. 100,000
Expected life:	Rs. 5 years
Depreciation rate:	20%

SOLUTION

Particulars	Depreciation (Rs)	Accumulated Depreciation (Rs.)	Written Down Value (Rs.)
Depreciable cost			100,000
Dep. Of the 1st year 100,000 x 20%	20,000	20,000	80,000
Dep. Of the 2nd year 80,000 x 20%	16,000	36,000	64,000
Dep. Of the 3rd year 64,000 x 20%	12,800	48,800	51,200
Dep. Of the 4th year 51,200 x 20%	10,240	59,040	40,960
Dep. Of the 5th year 40,960 x 20%	8,192	67,232	32,768

You see, at the end of five years, WDV of the asset is Rs. 32,768, not zero. But in case of straight line method, the WDV, after five years was zero. So, in the opinion of some people, reducing balance method is better than that of straight line method, but both methods are effective. It is the management, that has to decide, which method is best suited to their business.

Once an asset has been fully depreciated, no more depreciation should be recorded on it, even though the property may be in good condition and may be in use. The objective of depreciation is to spread the cost of an asset over the periods of its usefulness; in no case can depreciation be greater than the amount paid for the asset. When a fully depreciated asset is in use beyond the original estimate of useful life, the asset account the accumulated depreciation account should remain in the accounting records without further entries until the asset is retired.