

CLASS NOTES

Class: XI

Topic: DEPRECIATION, PROVISIONS AND RESERVES

Subject: ACCOUNTANCY

*Write the following notes in your class note book

INTRODUCTION TO DEPRECIATION

- The word depreciation has been derived from the Latin word 'Depretium' which means 'decline in price or Value'.
- Therefore, depreciation means decline in the value of fixed assets on account of usage and various other factors, such as passage of time or obsolescence.

DEFINITION OF DEPRECIATION

According to ICAI—“Depreciation is a measure of the wearing out, consumption or other loss of value of depreciable assets arising from use, defluxion of time or obsolescence through technology and market changes.

OTHER TERMS RELATED TO DEPRECIATION

DEPLETION-

- The term depletion is used in relation to natural resources or wasting assets such as mines, oil wells, timber, trees etc.
- As the resource is extracted or removed. Its asset value will decline.

AMORTIZATION-

- It refers to the process of writing-off the cost of an intangible asset over a future period covering its expected useful life.
- This applies to patents, goodwill, copyrights etc.

CHARACTERISTICS OF DEPRECIATION

- Depreciation is a decline in the value of fixed assets (except land).
- It is a continuing process.
- Is a non cash expense.
- It is an expired cost.
- It includes loss of value due to effluxion of time, usage or obsolescence.
- The term depreciation is used only for tangible fixed assets.

CAUSES OF DEPRECIATION

- **Constant use**-Constant use of asset leads to wear and tear of asset which results in decline in the Value of asset.
- **Passage of time**- Even if the assets are not put to use, their value decreases due to expiry of time.
- **Expiry of legal rights**-Value of intangible assets like patents, copyright, trademarks, leases etc., becomes nil after a predetermined period. It is also referred as Amortization.
- **Obsolescence**-Obsolescence means 'out of date'. When old assets become outdated, then it loses its value.
- **Depletion of Assets**-It is the decrease in the value of natural assets such as mines, oil-wells etc., due to constant extraction.

- **Abnormal Reasons**-Abnormal reasons like fire, floods or other natural calamities may lead to decline in the value of assets.

NEED FOR DEPRECIATION

- To ascertain True Net Profit or Net Loss.
- Consideration of Tax.
- True and Fair Financial Position.
- Compliance with the law.

FACTORS AFFECTING THE AMOUNT OF DEPRECIATION

The determination of depreciation depends on the following parameters

1.**ORIGINAL (HISTORICAL) COST OF THE ASSETS**-It includes Purchase Price+ Freight+ Installation Cost

2.**EXPECTED USEFUL LIFE**-The tenure in which the asset will remain useful.

3.**ESTIMATED NET RESIDUAL VALUE**-The value at which scrap can be sold-Expenses (if any)

4.**DEPRECIABLE VALUE**-Cost of asset-Residual Scrap value

METHODS OF CALCULATING DEPRECIATION

1)STRAIGHT LINE METHOD

2)WRITTEN DOWN VALUE METHOD

STRAIGHT LINE/FIXED INSTALLMENT/ORIGINAL COST METHOD-

- Under this method a fixed and equal amount in the form of depreciation is charged every year during the life time of the asset.
- It is called as straight line because if the amount of depreciation and corresponding time period is plotted on a graph, it will result in a straight line parallel to the X-axis.
- As the amount of depreciation remains equal from year to year, it is also called as fixed or equal installment method.

Depreciation under this method can be calculated in the following two ways:

(1)BY USING THE FORMULA-

$$\text{DEPRECIATION}=\text{COST OF ASSET}-\text{SCRAP VALUE}/\text{ESTIMATED LIFE}$$

(2)AS A PERCENTAGE OF ORIGINAL COST-

$$\text{DEPRECIATION}=\text{COST OF ACQUISITION} \times \text{RATE OF DEPRECIATION}/100$$

(RATE CAN ALSO BE DETERMINED WITH THE HELP OF THE FOLLOWING FORMULA

$$\text{RATE OF DEPRECIATION}=\text{ANNUAL DEPRECIATION AMOUNT}/\text{COST OF ASSET} \times 100$$

WRITTEN DOWN VALUE METHOD/REDUCING BALANCE METHOD/DIMINISHING BALANCE METHOD

- Under this method, depreciation is charged at a fixed rate on the book value

(Written Down Value) of the asset rather than original cost

- The amount of depreciation goes on reducing, year after year.
- The value of the asset diminishes at diminishing rate.

DIFFERENCE BETWEEN FIXED INSTALLMENT METHOD AND DIMINISHING BALANCE METHOD-

- Straight Line Method is a simple method of calculating depreciation as it is once calculated, whereas it is to be calculated every year under diminishing method.
- Assets can be depreciated fully in case of fixed method whereas under diminishing method asset can never be reduced to zero.
- Diminishing method is an approved method of depreciation by income tax authorities.