Unit. 5

Depreciation Accounting.

Meaning: Depreciation is a permanent decline in the value of an asset. The gradual, decrease, both in the value and usefulness, of an asset due to its nature and usage is termed as depreciation.

Methods of Recording Depreciation.

Depreciation can be recorded in the books of accounts by two different methods:-

I When a provision for depreciation Account is not maintained:

Under this method the amount of depreciation is debited to the depreciation account and Credited to the asset account. Depreciation account is closed by transfer to profit and loss account, and is shown as a deduction from the value of the asset on the assets side of the balance sheet.

The following journal entries are passed in case depreciation is provided according to this method.

(i) For providing Depreciation:

Depreciation A/c Dr

To Asset A/c

(ii) For transferring depreciation to the P&L A/c.

Profit & Loss A/c Dr.

To Depreciation A/c.

(iii) When the asset is Sold;

Bank A/c Dr

To Asset A/c

(iv) For the depreciation (on the sold asset) of the current period.

Depreciation A/c

To Asset A/c

(v) For loss on sale of asset:

Profit & Loss A/c.

To Asset A/c.

Reverse entry will be passed when there is profit on sale of an asset.

(ii) When a provision for depreciation A/c is maintained:

Under this method, the amount of depreciation to be provided in a particular year is credited to provision for depreciation account and debited to profit and loss account. The balance, if any, in the asset account is transferred to the profit & Loss account. The following Journal entries are passed under this method:

(i) For providing depreciation:

Depreciation A/c Dr
To provision for Depreciation A/c

(ii) For transferring depreciation to profit & loss A/c:

Profit & Loss A/c Dr
To Depreciation A/c.

(iii) When Asset is sold;

(a) For transferring accumulated depreciation,

Provision for Depreciation A/c Dr
To Asset A/c

b) For Sale proceeds of the asset;

Bank A/c Dr

To Asset A/c.

c) For profit on sale;

Asset A/c Dr.

To profit & Loss A/c.

(d) For loss on sale;

Profit & Loss A/c Dr.

To Asset A/c

Method: of providing Depreciation:

I Stright Line Method:

Under this method, depreciation is charged evenly every year throght the effective life of an asset.

$$\text{Depreciation} = \frac{\text{Cost of the fixed asset} - \text{Scrap value}}{\text{No. of years of expected life.}}$$

Merits:

1. This is very simple and easy to calculate.
2. Value of asset can be reduced to zero.
3. It is suitable, for those whose working can easily be estimated.

V Diminishing balance method or reducing instalment method:

Under this method, depreciation is charged at fixed rate on the reducing balance every year. In other words, depreciation is calculated on the book value of the asset each year. Thus the amount of depreciation goes on decreasing every year.

Merits:

(i) It is recognised by Income-tax authorities as well as companies Amendment Act 1988.

(ii) Elimination of a major portion of cost in earlier years also minimises the impact of obsolescence.

(iii) The asset is never completely written off so that some charge is made to revenue, every year.

VI Annuity Method:

Under this method, interest at a fixed rate is calculated on the capital investment involved in the purchase of the asset, on the assumption that, if the same amount of capital was employed in some other investment, it would have earned a certain rate of interest.