

Chapter - 5 Depreciation and Amortisation

(4-8 marks)

* What is an Asset ?

Asset is a resource

- Owned / controlled by the owner / business.
- Result of past event (Purchase)
- Future Economic Benefits

* What is depreciation ?

In simple words, depreciation means reduction in value of a fixed asset due to any reason.

According to Companies Act, depreciation means systematic allocation of capital expenditure (cost price) over useful life of asset.

* Reasons for Depreciation :

- Due to wear and tear
- Due to passage of time
- Due to change in technology
- Due to decrease in market value

For example,
A machine of Rs 500000 is purchased for 5 years, hence cost price of Rs 500000 should be allocated in 5 years systematically.

⇒ Depreciation is a charge against Profit and it is provided even if there is loss.

⇒ Depreciation is a non-cash expense and operating expense.

* Objective of Providing Depreciation

- To know correct profit
- To know correct financial position
- To know actual cost of production
- Provides fund for depreciation.
- [Benefit in tax]

Eg: Profit before ~~tax~~ ^{dep.} = Rs 200
 - Depreciation = Rs (80)
 = Profit after dep. = Rs 120

Tax rate 30%. → Profit before dep.
 = $200 \times 30\%$ → Rs 60
 → Profit after dep. → $120 \times 30\%$ → Rs 36

$$\therefore \text{Benefit in tax due to depreciation} = 60Rs - 48Rs \\ = \boxed{24Rs}$$

* Factors to be considered while providing depreciation:

Factor 1 $\rightarrow$ Cost price of Asset

Factor 2 $\rightarrow$ Residual price (End of Asset Life)

Factor 3 $\rightarrow$ Useful ~~life~~ life of Asset

$\rightarrow$ What is cost price of Asset?

Purchase Price of Asset (MRP)	xxx
- Trade Discount	(xxx)
+ Non-refundable tax	xxx
Invoice price	xxx
+ Loading & Unloading charges	xxx
+ Transportation cost	xxx
+ Transit Insurance	xxx
+ Installation cost	xxx
Cost price of Asset	<u>xxx</u>

→ What is residual value?

Residual Value means estimated amount that will be recovered at the end of useful life of ~~asset~~ asset.

→ What is Useful Life of Asset?

It means the period for which asset will provide economic benefit to business.

It is always estimated and decided by Management.

* Specimen Journal Entry:

Year 1

a) When asset is purchased

Asset a/c Dr.
To bank a/c
To cash a/c

b) When depreciation is provided

Depreciation a/c Dr.
To Asset

c) When depreciation is transferred
to P/L a/c:

Profit and loss a/c Dr.
To depreciation a/c

(Entry b and c will be passed every year till the asset is sold)

d) When asset is sold:

(i) At profit:

Bank a/c Dr.
To Asset
To profit on sale of asset

(ii) At loss:

Bank a/c Dr.
Loss on sale of asset a/c Dr.
To Asset

* Methods to provide depreciation:

1) Straight line Method / Fixed Installment Method:

P.T.O

- Under this method, the amount of depreciation will remain identical / equal.
- This method is used for assets like building, leasehold property, etc....
- This method assumes that asset is used equally every year. (Practically it is not possible)

Formula to calculate depreciation as per SLM:

a) When life of asset is given:

$$\text{Depreciation p.a.} = \frac{\text{Cost price} - \text{Residual value}}{\text{Useful life}}$$

b) When rate of depreciation is given:

$$\text{Depreciation p.a.} = \text{Cost price} \times \text{Rate}$$

$$\text{Rate} = \frac{\text{Depreciation}}{\text{Cost price}} \times 100$$

Eg: Cost price of Asset $\rightarrow$ Rs 800000
Residual value $\rightarrow$ Rs 500000

Calculate depreciation if.

a) Life of asset is 10 years.

b) Rate of depreciation is 15%.

$$a) \text{ Depreciation} = \frac{\text{C.P} - \text{R.V}}{\text{useful life}}$$

$$= \frac{800000 - 50000}{10}$$

$$= \boxed{75000 \text{ Rs pa.}}$$

$$b) \text{ Depreciation} = \text{Cost price} \times \text{Rate}$$

$$= 800000 \times \frac{15}{100}$$

$$= \boxed{120000 \text{ Rs p.a.}}$$

$\Rightarrow$ Rate in Case A:

$$\text{Rate} = \frac{\text{Depreciation}}{\text{cost price}} \times 100$$

$$= \frac{75000}{800000} \times 100$$

$$= \boxed{9.38\%}$$

* Reducing Balance Method:

- Under this method, the amount of depreciation will decrease every year.
- ~~Here~~ ^{He}, the value of asset will never become zero (0).
- Under this method, balance is maintained between repair or maintenance cost and depⁿ.
 Repair/Maintenance cost (↑)
 Depreciation (↓)
- This method is appropriate for assets like machinery, furniture, plant, etc.....

Formula:

$$\text{Depreciation for p.a} = \frac{\text{Opening book value} \times \text{Rate of dep}^n}{100}$$

Eg: Machine of Rs 500000 is purchased on 1/7/23 and installation expense of Rs 50000 is incurred. Machine

is depreciated @ 10% p.a.
 Calculate depreciation for 3
 years starting from 2023-24,
 by
 ① SLM
 ② WDM

→ By SLM:

~~Depreciation p.a = $\frac{\text{Cost price}}{\text{Rate (in years)}}$

= $\frac{(500000 + 50000)}{10\% \times \frac{9}{12}}$

= $550000 \times 10\% \times \frac{9}{12}$

~~₹ 150000~~

~~₹ 41250~~~~

Solution:

	SLM	WDM
Purchase price	500000	500000
+ installation	50000	50000
Cost price →	550000	550000
- Dep ⁿ @ 10% (9m)	(41250)	(41250)
Book value (1-4-24)	508750	508750
(24-25) - Dep ⁿ @ 10% (12m)	(55000)	(50875)
Book value (1-4-25)	453750	457875
(25-26) - Dep ⁿ @ 10% (12m)	(55000)	(45788)
	398750	412087