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# A CONCEPTUAL FRAMEWORK ON DEPRECIATION

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## ABSTRACT

*The essence of research is to acquire knowledge. Information is the base of knowledge. The preparation of a research report is the end result of a study. Depreciation is considered as one of the most important accounting practices in a firm. That's why it became an area of research and concentration for many years. This research paper is an attempt to present a brief framework of depreciation concept.*

***Keywords:*** Depreciation, Fixed Installment Method, Diminishing Balance Method, Sums of the Digits Method, Annuity Method.

## INTRODUCTION

### Concept of Depreciation

**Depreciation accounting:** One of the basic objectives of financial accounting is to calculate the true profit of loss from the operation of the enterprise for a particular period. .As per matching principle of accountancy the costs of the products must be matched with the revenues in each period. This principle indicates that if any revenue is earned and recorded then all costs whether paid or outstanding must also be recorded in books of account so that the profit and loss account could give a true and fair view of the profits earned or loss suffered during the period and balance sheet presents true and fair view of a financial position of the business.

The accounting concept of depreciation refers to the process of allocating the initial or re-stated input valuation (cost or other basis) of plant and equipments to their useful life and charge the amount to revenue account as expenditure.

Depreciation is charged on the fixed assets or those assets which are of material value having long life and are held to be used in business and are not primarily for resale or for conversion into cash. Usually, with the exception of land, fixed assets have a limited number of the years of useful life. Motor vans, machines, buildings and fixtures, for instance do not last for ever. Even land itself may have all or part of its usefulness exhausted after few years. Some types of lands used for quarries, mines or land of another sort of washing nature would be examples. When a fixed asset bought is put out of use by the firm, that part of the cost that is not recovered on disposal is called depreciation.

**Definition of Depreciation:** The American institute of certified public accountants has defined the depreciation as "Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. *It is a process of allocation, not valuation*. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to the effect of all such occurrences."

Some definitions given by prominent authors and institutes of accountancy are given below:

- Depreciation may be defined as the permanent and continuous diminution in the quality, quantity or value of an asset. …………Pickles
- Depreciation is diminution in the intrinsic value of asset due to use and/or the lapse of the time…………ICMA Terminology
- In simple words, depreciation can be defined as a permanent, continuing and gradual shrinkage in the book value of a fixed asset…………..A N Agarwal.

From the above definitions it is clear that depreciation is the gradual, continuing and permanent fall in the value of fixed assets. The main causes for this fall in value are wear and tear of assets accidents, passage of time, obsolescence, inadequacies, depletion etc. even in the recent edition of English language dictionaries the word 'depreciation' has been described as "decline in the value of an asset due to such causes as wear and tear, action of elements, obsolescence and inadequacy." Although these traditional views are under pressure because of the recognition of the changes in the value of rupee and replacement costs, (Development of inflation accounting and replacement value technique) even then they have their historical significances.

**Causes of Depreciation:** Following are the main causes of depreciation:

1. Physical deterioration
2. Economic factors
3. Time factor
4. Depletion

**Physical deterioration**: It is caused mainly from wear and tear when the asset is in use and from erosion, rust, rot and decay from being exposed to wind, rain, sun and other elements of nature.

**Economic factors**: These may be said to be those that cause the asset to be put out of the use even though it is in good physical condition. These arise due to obsolescence and inadequacy. Obsolescence means the process of becoming obsolete or out of date. Old machinery in good physical conditions may be rendered obsolete by the introduction of new model which produce more than the old machinery. Inadequacy refers to the termination of the use of an asset because of growth and changes in the size of the firm. But obsolescence and inadequacy do not necessarily mean that the asset is scrapped. It is merely put out of use by firm. Another firm will often buy it.

**Time factor**: There are certain assets with a fixed period of legal life such as lease, patents and copyrights. For instance, a lease can be entered into for any period while a patent's legal life is for some years but on certain grounds this can be extended. Provision for the consumption of these assets is called amortization rather than depreciation.

**Depletion**: Some assets are of wasting characters perhaps due to extraction of raw materials from them. These materials are then either used by the firm to make something else or are sold in their raw state to other firms. Natural resources such as mines, quarries and oil wells come under this heading. To provide for the consumption of an asset of a wasting character is called provision for depletion.

**Need for providing depreciation:**

1. To know the correct profits.
2. Show correct financial position.
3. Make provision for replacement of assets.

## Methods of Depreciation

Different methods of calculating provision for depreciation are mainly accounting customs which may be used by different concerns taking into consideration the individual peculiarities. The following are the main methods of providing depreciation.

1. Fixed Installment Method.
2. Diminishing Balance Method.
3. Sums of the Digits Method.
4. Annuity Method.
5. Depreciation Fund Method.
6. Insurance Policy Method.
7. Revaluation Method
8. Depletion Method
9. Machine Hour Rate Method,

Some prominent methods out of above are succinctly touched below.

**Fixed Installment Method**: It is also known as fixed percentage on original cost of straight line method. Under this method a fixed percentage of the original value of the asset is written off the estimated life of the asset. To ascertain the annual charge under this method that is necessary is to divide the original value of the asset (minus its residual value if any) by the number of years of its estimated life.

Depreciation = (cost of asset – scrap value at the end) / life of the asset ( No. of Years)

**Diminishing Balance Method**: This method is also known as reducing installment method or written down value method. Under this method, depreciation will be calculated at a certain percentage each year on the balance of the asset which is brought forward from the previous year. Every year the installment of depreciation will reduce as the beginning balance of the asset in each year will reduce. It is usually adopted for plant and machinery.

The advantages of this method are:

- It tends to give a fairly even charge of depreciation against revenue each year. Depreciation is generally heavy during the first few years and is counterbalanced by the repairs being light and in the later years when repairs are heavy this is counterbalanced by the decreasing charge for depreciation.
- As and when additions are made to the asset, fresh calculations of depreciation are not necessary.
- This method is recognized by the income tax authorities in India.
- Its main drawback is that in subsequent years, original cost of asset is altogether lost sight of and the asset can never be reduced to zero under this method. Further this method does not take into consideration the asset as an investment and interest is not taken into consideration.

**Sums of the Digits Method**: this is a variant of the reducing instslment or diminishing balance method. Under this method depreciation is calculated by the following formula:

$$\text{Depreciation} = \text{Amount to be written off} \times \frac{\text{Number of years of the remaining life of the asset including the current year}}{\text{the total No. of al the digits representing the life of the assets (in years)}}$$

**Depreciation Fund method** : under all the methods discussed up till now, ready cash may not be available when the time of replacement comes because the amount of depreciation is retained n the business it self in the form of assets not separate from other assets which can not be readily sold.

The method (applied to long leases etc.) implies that the amount written off as depreciation should be kept aside and invested in readily saleable securities. The securities accumulate and when the life of the asset expires, the securities are sold and with the sale proceeds a new asset is purchased. Since the securities always earn interest, it is not necessary to provide for the full amount of depreciation, some thing less will do. How much amount is to be invested every year so that a given sum is available at the end of a given period depends on the rate of interest which is easily calculated from Sinking Fund Tables.

## Factors Influencing the Choice of a Depreciation Method

The choice of depreciation method is an important decision. The nature of asset, tax considerations, price fluctuations, accounting conventions, obsolescence, management policy is some of the important factors which influence this decision. It is noteworthy to mention that selection of depreciation method is a managerial decision.

## OBJECTIVE OF STUDY

1. The main objective of the study is to render a better understanding of the concept of depreciation.
2. To throw a light on those causes which in fact give birth to depreciation resulting in to non- cash expenditure.

## CONCLUSION

Gradual decline in the total cost of the asset during the course of its working life till it becomes obsolete. Depreciation = Total cost of the asset *minus* scrap value. is a non-cash expense which reduces the value of a fixed asset except Land as a result of wear and tear, age, or obsolescence. Most assets lose their value over time (in other words, they depreciate), and must be replaced once the end of their useful or economic life is reached. There are several accounting methods that are used in order to write off an asset's depreciation cost over the period of its useful life because it is a non-cash expense, depreciation lowers the company's reported earnings while increasing free cash flow. In a simple word depreciation is all about the reduction in the value of fixed assets and the allocation of the cost of assets to periods in which the assets are used.

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