

# Topic 7



# Depreciation

# DEPRECIATION

1. Reduction in the useful economic life of tangible non current assets.
2. Consumption of non current asset over a period of time.
3. Decrease in the value of tangible non current assets.
4. Systematic Decrease in the value of tangible non current assets.

Note: All non current assets need to be depreciated except land as it has an infinite or unlimited useful life.

- Reduction in value of intangible non current assets e.g.: goodwill, patents is called amortization.
- Reduction in value of natural resources is called depletion.

Causes/Factors of Depreciation:

1. Physical Factors
  - wear and tear
  - rust and dust
2. Economic Factors
  - Obsolescence (outdate/obsolete)
  - Madequacy (no longer required/insufficient)
3. Time Factor (for leasehold assets)

Reasons for charging depreciation:

To spread the cost of an asset over its useful economic life as per the matching/accrual concept.

To ensure that the value of assets and profits are not overstated as per the prudence concept.

Methods of Depreciation:

1. Straight line method
2. Reducing (Diminishing) Balance method
3. Revaluation Method.

## Straight line Method:

• Annual Depreciation expense =  $\frac{\text{cost} - \text{scrap value}}{\text{useful life}}$

where;

Cost: purchase price of an asset + expenses incurred directly or legally on purchase of asset and in making it operational

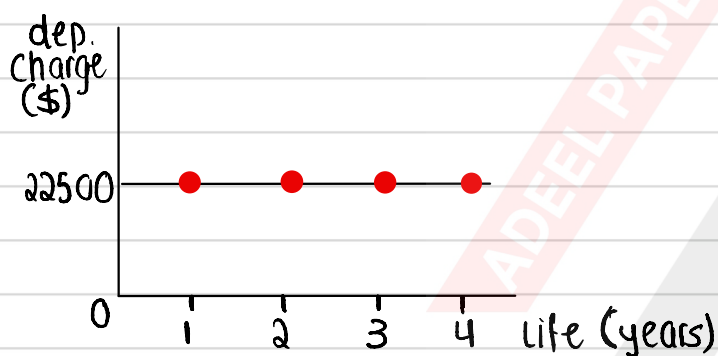
Scrap Value / Salvage value / Residual Value / Trade in Value:

expected saleable value at the end of useful life.

useful life: estimated economic life of asset

• fixed percentage / rate of depreciation is applied on original cost of asset

• depreciation expense each year remains constant



## Accounting entries:

i. Purchase / Acquisition of non current asset

non current asset ↑	dr xxx	cr
Cash / bank ↓		xxx

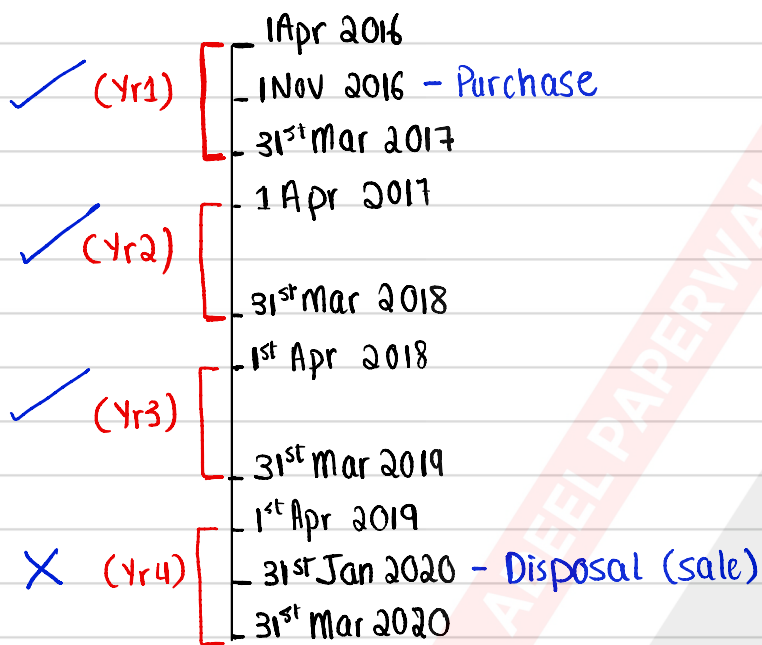
ii. Recording depreciation expense

income statement (dep. expense) ↓	dr xxx	cr
provision for depreciation ↑		xxx

## Depreciation Policies:

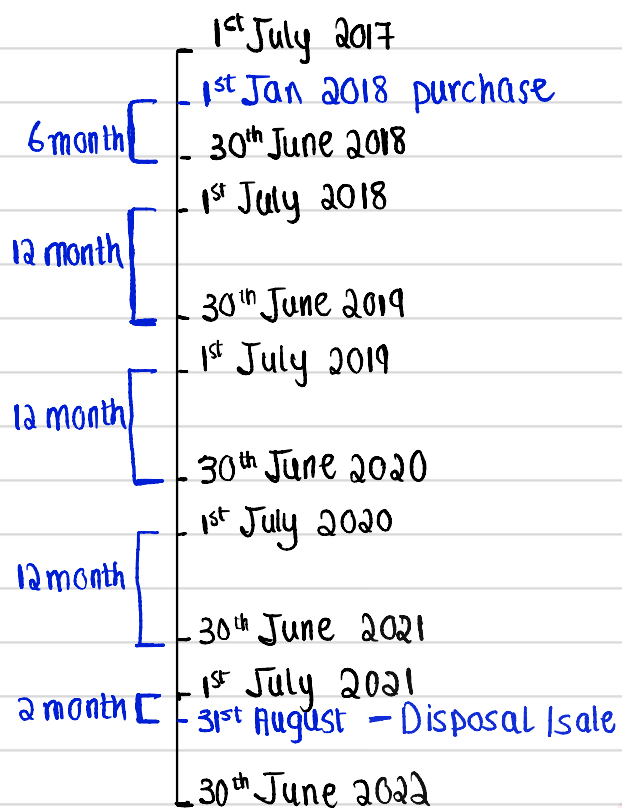
1. To charge a full year depreciation in the year of purchase but none in year of disposal.  
To charge depreciation on all non current assets held at year end.

Example: A business financial year is from 1<sup>st</sup> April till 31<sup>st</sup> March. The business sold a motor vehicle on 31<sup>st</sup> January 2020 which was purchased on 1<sup>st</sup> November 2016. Calculate how many years of depreciation was charged on this asset.

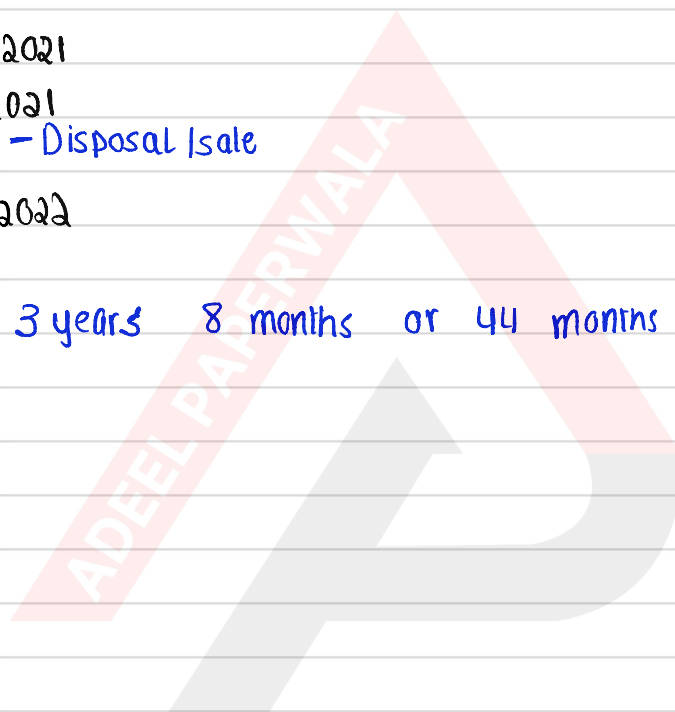


2. To charge depreciation on monthly basis /  
To charge depreciation on proportionate basis.

Example: A business purchased a non current asset on 1<sup>st</sup> January 2018 and it was sold on 31<sup>st</sup> August 2021. The business financial year is from 1<sup>st</sup> July till 30<sup>th</sup> June. Calculate how many years of depreciation was charged on this asset.



Total Depreciation = 3 years 8 months or 44 months



Example::

List price of machinery = \$100000

Trade Discount = 20%.

Delivery charges = \$4000

Installation charges = \$6000

Useful life = 4 years

Scrap value = nil

Required::

a. Calculate the cost of the asset

b. Annual Depreciation Charge

c. Rate of Depreciation

d. Calculate gain/loss on disposal if asset was sold after 3 years for \$7500.

e. Prepare disposal account.

a. Cost of the Asset

List price	\$ 100000
(-) trade discount (20%)	(20000)
= net invoice value	80000
+ carriage	4000
+ installation charges	6000
= <u>Cost of asset</u>	<u>90000</u>

b. Depreciation expense =  $\frac{\text{cost} - \text{scrap value}}{\text{useful life}}$

$$= \frac{\$90000 - 0}{4 \text{ years}}$$
$$= \$22500/\text{year} \text{ (annual)}$$

c. Rate of Depreciation =  $\frac{100\%}{\text{useful life}}$  OR  $\frac{\text{depreciation expense} \times 100}{\text{cost} - \text{scrap value}}$

$$= \frac{100\%}{4}$$
$$= 25\%$$
$$= \frac{\$22500 \times 100}{\$90000 - 0}$$
$$= 25\%$$

d. Accumulated Depreciation = \$22500 × 3 years  
= \$67500

		e. Disposal A/c	
Cost	\$ 90000	→ machinery 90000 (cost)	→ prov. for dep. 67500
(-) Accumulated depreciation	(67500)		
= Netbook value	22500	→ cash/bank 7500	
(-) Sale Proceeds	(7500)	→ Loss (I/S) 15000	
= Loss on Disposal	15000	90000	90000

### Accounting entries on disposal

i. disposal a/c

dr  
xxx

cr

asset a/c ↓

xxx

[with the amount of original cost of asset]

ii. provision for depreciation ↓

dr  
xxx

cr

disposal a/c

xxx

[with the amount of accumulated depreciation charged during its operating life]

iii. bank/cash ↑

dr  
xxx

cr

disposal a/c

xxx

[with the amount of sale proceed received on disposal]

iv. Gain/Loss on disposal

• if gain on disposal

disposal a/c

dr  
xxx

cr

income statement ↑ (Revenue)

xxx

• if loss on disposal

income statement ↓ (Expense)

disposal a/c

dr  
xxx

cr

xxx

Note: There is no opening or closing balance in disposal account.

Example:

bid

The following information is available on 1<sup>st</sup> January 2021.

\$

motor vehicles at cost	60000
accumulated depreciation	15000

It is business policy to charge depreciation on monthly basis using 20%/annum straight line method.

The following changes took place in year 2021:

- i. Purchased new motor vehicle costing \$20000 on 1<sup>st</sup> April 2021
- ii. Sold an old motor vehicle purchased on 1<sup>st</sup> March 2019 for \$3600. The asset was sold on 30<sup>th</sup> June 2021 and originally cost \$12000.

Required:

- i. Calculate gain or loss on disposal
- ii. Prepare disposal account.
- iii. Calculate depreciation charge for 2021.

1 <sup>st</sup> January 2021 - year start	bid	<u>Cost</u> \$60000
1 <sup>st</sup> April 2021 - Additions		\$20000
30 <sup>th</sup> June 2021 - Disposal (cost)		<u>(\$12000)</u>
31 <sup>st</sup> December 2021 - year end	c/d	\$68000

# INTRODUCTION TO COST AND MANAGEMENT ACCOUNTING

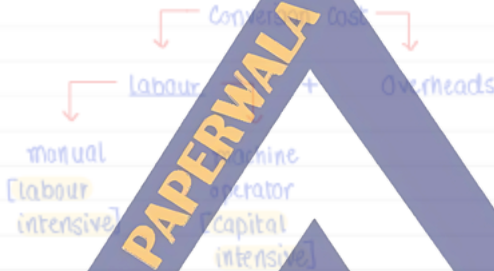
Cost/Expense: Outflow of resources.

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Stages of Manufacturing

1. Input [raw material] → 2. Process → 3. Output [finished goods]



Labour intensive business: Business organisations dependant on manual labour rather than technology or machinery.

Capital intensive business: Business organisations which are more dependant on machines rather than manual labour.