**Depreciation**

Depreciation is the cost of an asset. It represents the consumption or loss of future economic benefits.Depreciation is the allocation as an expense during each accounting period, of the depreciable amount of an asset, over its useful life. Depreciable amount means the cost of an asset less its re-sale value.

The **purpose** of depreciation is to reflect in the financial statements, how the future economic benefits contained in the asset are consumed. Depreciation shows how much of the depreciable asset has been used to earn income.

The **nature** of depreciation is that it is a non-cash expense. Depreciation is a book entry in an accounting system that does not involve a cash inflow or cash outflow. This entry does not set aside cash for the replacement of an asset. Due to wear and tear, usage, obsolescence and perhaps legal limits, the asset ceases to provide the same amount of economic benefit and the depreciation expense accounts for this.

Depreciation is a process of expense allocation not asset valuation. The process is not intended to arrive at the current market value of a depreciable asset. Depreciation is the allocation of the historic cost over it’s useful life. The depreciation expensed is an attempt to match the income earned during each accounting period to the amount of the asset consumed earning that income. The allocated depreciation expense is a book entry that does not involve cash so will therefore not be related to funds held to purchase future assets.

**Causes of Depreciation**

* Wear and tear: the decline of an asset due to use
* Technical obsolescence: the asset is redundant due to new technology causing it to no longer be useful
* Commercial obsolescence: the asset is redundant due to a declining demand for the goods and services that the asset was used to produce

**Differences between Straight-line Method and Reducing Balance Method:**

* SLM records the same amount of depreciation in each full year, whereas the RBM records more in the earlier years of the asset’s life.
* SLM is more appropriate when the asset earns income evenly over its useful life,whereas the RBM is more appropriate for assets that generate a higher level of income in its earlier years.
* RBM is more appropriate form machines as they will yield more service in its earlier years than in later years.

**Under and over depreciation**

When a depreciable asset is sold and there is a gain on sale, this is because too much depreciation has been expensed over the life of the asset. The asset has been over depreciated.

When a depreciable asset is sold and there is a loss on sale, this because not enough depreciation has been expensed over the life of the asset. The asset has been under depreciated.