Depreciation

Lecture 20

Depreciation

- What?
  - Reduction in value of the asset due to various causes.

- Why Depreciation?
  - Because assets undergo wear and tear
  - Because they become obsolete
  - Because they exhaust
    - They have limited useful time
  - Because they lapse (for e.g., patents, copyright)

- Business Advantages
  - Tax savings
  - Correct Ascertainment of Profits
  - Visibility into time frame needed to replace asset

Types of Depreciation

- Straight Line
  - Simple method depreciation
  - If salvage value is known, depreciation can be calculated easily.
  - Assume you bought a car for Rs.5,00,000. This is your asset acquisition cost.
  - If you know that you can sell your car for say Rs.1,00,000 after 5 years of its use, then that Rs.1 lakh is salvage value and 5 years is the asset's useful life.
  - So Depreciation Expense = (Total Acquisition Cost – Salvage Value)/Useful Life

Types of Depreciation

- Units of Output/Production
  - Unlike straight line method that employs time period, Units of Output method employs total units a machine can produce during its lifetime
  - If the car example is taken, then the unit of output could be number of Kilometres the car plies before it breaks down.
  - If it is a machinery producing nuts and bolts, then the unit of output could be the Number of units of nuts and bolts produced by the machine over its lifetime.
  - So Depreciation Expense = (Total Acquisition Cost – Salvage Value)/Estimated Total Units

Types of Depreciation

Is straight line a good method to calculate Depreciation?

What about Maintenance Costs?

Hours of service Depreciation

- Same as Unit of Output Depreciation but the denominator used is No. of hours of service offered by the asset.
- Depreciation Expense = (Total Acquisition Cost – Salvage Value)/Total No. of hours of service