Chapter 6

Depreciation

1. Basic Terms

1.1 Assets eligible for Depreciation

As per **A/cing Standard – 10,** Property, Plant and Equipment (PPE) are –	1. Tangible Items that are held for – (a) Use in the production or supply of goods or services, (b) Rental to others, or (c) Administrative Purposes, } and 2. Tangible Items that are expected to be used more than 12 Months. **Note:** Items such as Spare Parts, Stand–By & Servicing Equipment are treated as **PPE,** if they meet the definition above. Otherwise, they are treated as **Inventory.**

Note: PPE is referred to as Fixed Assets in common parlance.

1.2 Depreciation

1. **Meaning:** It is the systematic allocation of the Depreciable Amount of an Asset over its Useful Life. So, Depreciation is –

A Measure of –	Arising from –
(a) Natural wear and tear, (b) Consumption, or (c) Other loss of value of a Depreciable Asset.	(a) Use, (b) Effluxion of time, or (c) Obsolescence through technology & market changes.

2. **Effect:** Depreciation refers to a reduction / loss in the utility of a Depreciable Asset.

3. **Nature:** Depreciation is a non–cash expenditure (i.e. it does not result in any cash outflow).

4. **Depreciation vs Amortisation:** Depreciation includes amortisation of assets whose useful life is predetermined. [**Note:** The term "Depreciation" is used in respect of Tangible Fixed Assets, and the term "Amortisation" is used in respect of Intangible Assets like Patents, Copyrights, etc.]

5. **Types:** Depreciation may be classified as under –

Type	Internal Depreciation	External Depreciation
Loss in utility or value due to	Natural Wear and Tear	Accident or Obsolescence

1.3 Purposes of Depreciation

Purposes: The main purposes of providing depreciation are –

1. **To keep intact, the capital invested in Fixed Assets:** This purpose is achieved by **retaining** in the business, the amount of depreciation charged in the Profit and Loss Account.
2. **To ascertain true cost of production:** The depletion of asset value due to usage should be charged in the accounts for determination of the true Cost of Production. This is done by charging depreciation.
3. **To determine profit or loss for the year:** Profits can be properly ascertained only after writing off the expense represented by the loss in value of Fixed Assets arising on their use.
4. **To present a true and fair value of Firm's assets** in the Balance Sheet on a going concern basis – Original Cost of assets decreases due to many factors and hence assets cannot be presented at their original costs. The amount of accumulated depreciation is deducted therefrom to reflect in the Balance Sheet, a true and fair value of the Fixed Assets.
5. **To provide for replacement of the Fixed Assets:** As the amount of depreciation charged in the P&L A/c is retained in the business (and not distributed as dividend), it goes on accumulating and eventually provides funds for replacement of Fixed Assets when their useful life is over.

Note: Merely charging depreciation in the books of accounts does not create funds for asset replacement. It only draws attention to the fact that out of the Gross Earnings / Receipts / Revenues, a suitable portion should be retained for replacement of assets used for carrying on operations.

1.4 Depreciation and Fluctuation in Value

Particulars	Depreciation in Value	Fluctuation in Value
1. Meaning	Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes.	Fluctuation is a temporary shrinkage or decrease / increase in the value of an asset, usually due to external causes such as rise and fall in market price of an asset.
2. Earning Capacity	It directly affects the earning capacity of an asset.	It does not affect the earning capacity or working life of an asset.
3. Effect in P&L A/c	It is a charge against the profit of the year.	No charge is made against the profit of the year.
4. Type of Asset	It is connected with Fixed Assets only.	It is connected with Fixed Assets and Current Assets.
5. Direction of Change	It is associated with a reduction in the value of Fixed Assets.	It may relate to increase or decrease in the value of any asset, Fixed or Current.

1.5 Depreciable Amount

'Depreciable Amount' is determined as under –

Particulars	₹
Cost of an Asset, or other Amount substituted for Cost in the Financial Statements	XXXX
Less: Estimated Residual Value	XX
Depreciable Amount	XXXX

Example: An item of Machinery was purchased by Anu Ltd for ₹ 18 Lakhs. It can be sold for ₹ 13.50 Lakhs currently, or for ₹ 2 Lakhs after 8 years, which is the useful life of the asset. The Depreciable Amount of the machinery will be ₹ 18 Lakhs – ₹ 2 Lakhs = ₹ 16 Lakhs. The current sale price is irrelevant.

1.6 Cost of Asset (PPE)

Principles relating to Cost of an Asset (PPE) are given below –

Aspect	Description
Cost	1. Amount of Cash / Cash Equivalents paid, or 2. Fair Value of the other consideration given } to acquire an Asset at the time of its Acquisition or Construction, or 3. Amount attributed to that Asset when initially recognised as per other AS.

Aspect	Description
Items included in Cost	1. Purchase Price **Add** Import Duties and Non–Refundable Purchase Taxes **Less** Trade Discounts and Rebates. 2. Any Costs directly attributable to bringing the Asset to the location and condition necessary for it to be capable of operating in the manner intended by Management. 3. Initial Estimate of Decommissioning, Restoration and similar Liabilities, i.e. the costs of dismantling, removing the item and restoring the site on which it is located, the obligation for which an Enterprise incurs either – (a) when the item is acquired, or (b) as a consequence of having used the item during a particular period for purposes other than to produce Inventories during that period.
Inclusions in Directly Attributable Costs	1. Costs of Employee Benefits arising directly from the construction or acquisition of the item of PPE, 2. Costs of Site Preparation, 3. Initial Delivery and Handling Costs, 4. Installation and Assembly Costs, 5. Costs of testing whether the Asset is functioning properly **Less** Net Proceeds from selling any items produced while bringing the Asset to that location and condition (e.g. Samples produced when testing Equipment), and 6. Professional Fees.
Items not included in Cost	1. Costs of opening a New Facility or Business, such as, Inauguration Costs, 2. Costs of introducing a New Product or Service(including Costs of Advertising and Promotional Activities), 3. Costs of conducting business in a new location or with a new class of customer (including costs of Staff Training), and 4. Administration and other General Overhead Costs.
Incidental Operations	1. Incidental Operations are **not** necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by Management. 2. Incidental Operations may occur before or during Construction / Development, e.g. Income earned through using a Building Site as a Car Park until construction starts. 3. Such items are recognized in Statement of P&L and included in their respective classifications of Income and Expense. They are **not** included as Cost of PPE.

	Situation	Cost Recognition [See **Note 1**]
Self–Constructed Asset	Self–Constructed Asset	Same Principles as for an Acquired Asset
	Enterprise makes similar Assets for sale in the normal course of business	Same Principles as the cost of constructing an Asset for sale as per AS–2.
	Recognition of Interest in the Carrying Amount of a Self–Constructed Item of PPE	Same Principles as per AS–16, Borrowing Costs

Note: Internal Profits, Cost of Abnormal Amounts of Wasted Material, Labour, etc. are **excluded** in recognising Cost of Self–Constructed Assets.

1.7 Factors for Depreciation

Assessment of depreciation and the amount of depreciation are usually based on the following **three** factors –

Cost or other amount substituted for Cost of the Depreciable Asset when the Asset had been revalued.	Expected **Useful Life** of the Depreciable Asset.	Estimated **Residual Value** of the Depreciable Asset.

These factors are explained as follows –

1. **Cost:** Refer Previous Para
2. **'Useful Life'** is either –
   (a) Period over which a depreciable asset is expected to be used by the Enterprise, **or**
   (b) Number of production or similar units expected to be obtained from the use of the asset by the Enterprise.

Situation	Useful Life
Ajay Ltd has purchased a new machinery for ₹ 5,00,000. The Company expects to use the asset for a period of five years.	Useful Life = Five years
Vijay Ltd has acquired a machinery for ₹ 8,00,000. The machine is usable for the production of a special product only upto 32,00,000 units. The Company plans to achieve this total production over a period of ten or twelve years.	Useful Life = 32,00,000 units

Note:

- Useful Life is always **shorter** than the physical life of an asset.
- Determination of the Useful Life of a depreciable asset is a matter of **estimation** and is normally based on various factors including experience with similar types of assets.

3. **Residual Value** is the amount likely to be obtained by the disposal of the Fixed Asset at the end of its Useful Life. The following points are to be noted in this regard –
   (a) If Residual Value of an asset is **insignificant**, it is normally regarded as **Nil**.
   (b) If Residual Value is significant, it is estimated either – (i) at the time of acquisition/installation, or (ii) at the time of subsequent revaluation of the asset.
   (c) Residual Value is estimated on the basis of Realisable Value of similar assets, which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

1.8 Quantum of Depreciation

1. **Basic Principle:** Depreciation is allocated so as to charge a fair proportion of the Depreciable Amount, in each accounting period during the expected useful life of the asset.
2. **Considerations:** The quantum of depreciation to be provided in an accounting period involves the exercise of judgment by management in the light of – (a) technical, (b) commercial, (c) accounting, and (d) legal requirements, and accordingly needs periodical review.
3. **Revision in Amount:** If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

1.9 Component–wise Computation of Depreciation

Companies Act, as well as Accounting Standard – 10 on Property, Plant and Equipment (PPE) requires Depreciation to be charged on a component–wise basis, explained as under –

1. **Basic Principle:** Each part of an item of PPE with a cost that is significant in relation to the total cost of the item should be depreciated **separately**.
2. **Treatment of Parts:**

Part of Item of PPE	Calculation of Depreciation
Part with a cost, significant in relation to Total Cost of the PPE item. **Example:** Airframe & Engines of an Aircraft, whether owned / subject to lease	Amount initially recognized in respect of such Item is allocated to its significant parts & depreciated **separately**.
Two Significant Parts of a PPE Item, having the same Useful Life and Depreciation Method.	Such Parts may be **grouped** in determining the Depreciation Charge.
Significant Parts of a PPE are depreciated separately, and the Remainder consisting of the Parts that are individually insignificant.	Approximation Techniques that faithfully represents its consumption pattern and/or useful life, may be used.
Parts of PPE that do not have a significant cost in relation to the Total Cost of the PPE	These may be depreciated separately, if the Enterprise chooses so.
Separable Assets (i.e. Land & Buildings) in which Buildings have a limited useful life and Land has an unlimited Useful Life	Accounted separately, even if they are acquired together. **Land:** Not Depreciated. **Buildings:** Depreciated. **[Note:** Increase in value of the Land on which a Building stands does not affect the determination of the Depreciable Amount of the Building.**]**
In case Land itself having limited useful life, e.g. Quarries and Sites used for landfill	It is depreciated in a manner that reflects the benefits to be derived from it.
Cost of Land includes the Costs of Site Dismantlement, Removal and Restoration	That portion of Land Asset is depreciated over the period of benefits obtained by incurring those costs.