DEPRECIATION

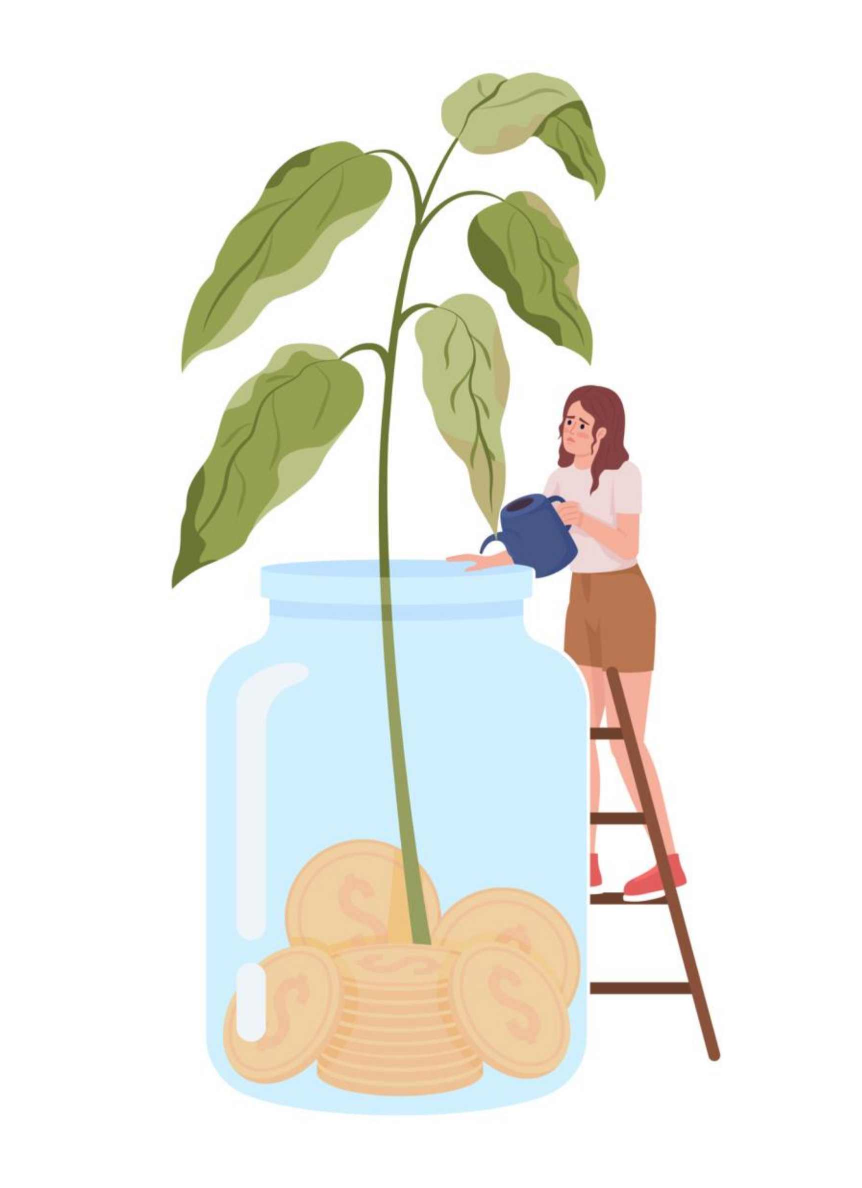
What you need to know

SHORT NOTES BY EMAN NISA

DEFINITION & PURPOSE

Depreciation is a systematic allocation of the cost of tangible assets over their useful lives. It represents the decrease in the value of an asset over time due to wear and tear, obsolescence, or other factors.

Depreciation is crucial for accurately reporting an organization's financial performance and asset management.



TYPES OF DEPRECIATION

Straight Line Method

Evenly spreads the asset's cost over its useful life. It is the simplest and most commonly used method, making it easier for financial reporting and tax purposes.

Reducing Balance Method

Applies a fixed percentage of depreciation to the asset's carrying value each year. It results in higher depreciation in the initial years and is often used for assets that lose value more rapidly early in their life.

Unit of Production Method

Bases depreciation on the asset's usage or output. The more the asset is utilized, the higher the depreciation expense.

CALCULATIONS

Straight Line Method

Depreciation Expense = (Cost of Asset – Salvage Value) / Useful Life

Where:

Cost of Asset is the initial cost of the asset.

Salvage Value is the estimated value of the asset at the end of its useful life.

Useful Life is the expected period the asset will be in service before it becomes obsolete or unusable.

Reducing Balance Method

Depreciation Expense = (Depreciation Rate x Carrying Value of Asset)

Where:

Depreciation Rate is a fixed percentage determined based on the asset's useful life and the chosen method.

Carrying Value of Asset is the remaining value of the asset after each year's depreciation is subtracted from the initial cost.

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Unit of Production Method

Depreciation Expense = (Cost of Asset – Salvage Value) / Total Units of Production

Where:

Cost of Asset is the initial cost of the asset.

Salvage Value is the estimated value of the asset at the end of its useful life.

Total Units of Production is the expected total units or output that the asset will produce or contribute to during its useful life. Depreciation is allocated based on the actual production or usage of the asset each period.

FACTORS AFFECTING DEPRECIATION

a) Useful life of an asset:

The expected period the asset will be in service before it becomes obsolete or unusable.

b) Salvage value:

The estimated value of the asset at the end of its useful life.

c) Depreciation methods chosen:

The method selected can significantly affect the amount and timing of depreciation expenses.

DEPRECIATION AND TAXATION

Depreciation is tax-deductible, meaning it can lower a company's tax liability, but it can also impact the recognition of capital gains when selling the depreciated asset.

FINANCIAL REPORTING AND DEPRECIATION

Balance Sheet

It reduces the asset's value on the balance sheet

Income Statement

Recorded as an expense on the income statement, affecting net income.

Cash Flow Statement

It's a non-cash expense, meaning it affects cash flow indirectly.

DEPRECIATION VS. AMORTIZATION

Tangible Assets

Depreciation applies to tangible assets and its value decreases over time due to wear and tear or obsolescence.

Intangible Assets

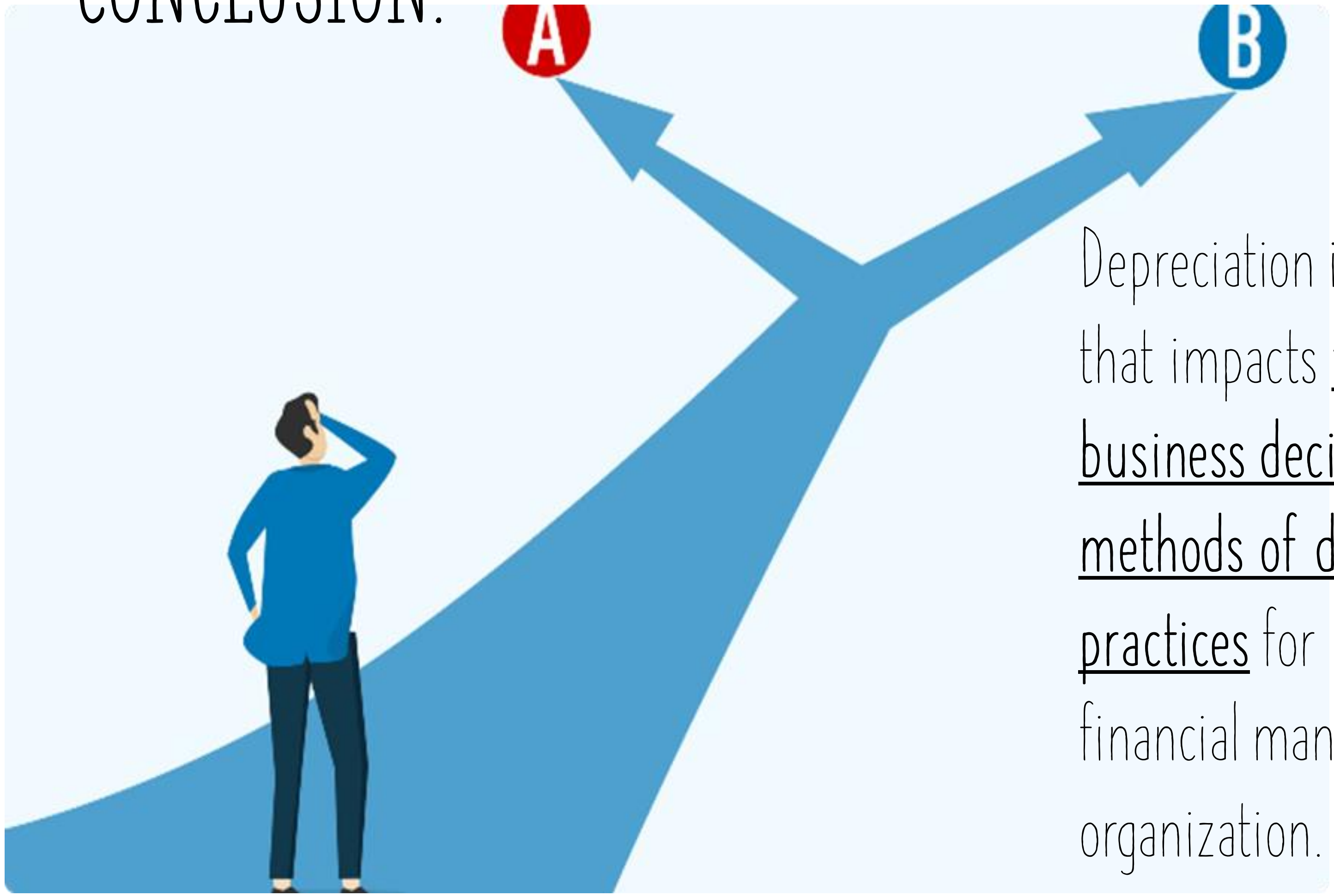
Amortization applies to intangible assets and its value decreases due to consumption, depletion, or obsolescence.

Both methods allocate an asset's cost over its useful life, provide a more accurate representation of a company's financial position and lower its tax liability.

IMPLICATIONS OF DEPRECIATION

- As assets depreciate, their book value decreases.
- This depreciation expense is used to allocate the asset's cost and generate funds for future replacement or upgrades.
- Understanding how depreciation affects asset values is crucial for making informed decisions regarding asset replacement or capital budgeting.

CONCLUSION:



Depreciation is a fundamental concept in accounting that impacts financial reporting, tax obligations, and business decisions. Understanding the different methods of depreciation, its implications, and best practices for managing it is crucial for effective financial management and decision-making in any organization.

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