

DEPRECIATION

Meaning

Depreciation is the measure of the wearing out, consumption or other reduction in the useful economic life of a fixed asset. It is loss of value of a fixed asset.

And this may arise from:

- Use of the asset eg Plant and machinery, motor vehicle etc
- Passing of time eg a term, year lease of property.
- Obsolescence through technology and market changes eg machinery of a specialized nature.
- Depletion eg extraction of minerals from a mine.

Purpose of Depreciation

The purpose of depreciation is to allocate the cost of the fixed asset over the expected life of that asset. It is not a method for providing for, or saving up for, replacement of fixed assets

Methods of Calculating Depreciation.

Methods of calculating depreciation are many but the following are the most common ones:

- i. Straightline method or Equal/Fixed Instalment method.
- ii. Reducing balance method or diminishing balance method.

NOTE: Examiners will specify which method is to be used in an examination. If they do not, the straight line method should generally be adopted as it is the easiest to use.

Straight line Method

Under this method, an equal amount is charged as depreciation for each year of the expected life of an asset. To calculate the depreciation charge, the following information is necessary:

- The original or historical cost of the asset.
- An estimate of its useful life to the business.
- An estimate of its residual value at the end of its useful life.

The depreciation charge is calculated as follows:

$$\text{Annual depreciation} = \frac{\text{Cost of asset} - \text{estimated residual value}}{\text{estimated useful life}}$$

EXAMPLE

A motor vehicle was purchased on 1st January, 2005 at a cost of K25,000. It is estimated that its useful life is eight (8) years, after which it will have a scrap value of K5000. Calculate the annual depreciation charge.

Solution

$$\begin{aligned} \text{Annual depreciation} &= \frac{\text{Cost of asset} - \text{estimated residual value}}{\text{estimated useful life}} \\ &= \frac{25,000 - 5,000}{8} = \frac{20,000}{8} \end{aligned}$$

$$\text{annual depreciation} = \text{K}2,500$$

EXERCISE

An office furniture was purchased on 31st December, 2015 at a cost of 31,000. It is estimated that its useful life is 4 years, after which it will have a scrap value of K6,000.

Required:

Calculate the annual depreciation charge

END

Next we will look at the second method of depreciation, which is the reducing balance method.