Accounting for Depreciation

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Depreciation is an accounting concept that allocates the cost of wear and tear to a tangible asset. Even with the best care, a tangible asset is bound to lose its value due to natural wear and tear process. This loss in value is accounted for using depreciation. In effect, depreciation indicates the annual loss in value of an asset. Depreciation is calculated as a non-cash expense because it originates from wear and tear, a process that does not involve any cash outflow. The remaining value of an asset after it has exhausted its useful life is called the salvage value.

In accounting process, most governments factor depreciation expense for business within their jurisdiction. Generally, this process is called capital deduction. In the US, the IRS indicates the different rates that an accountant should use when calculating the capital deduction expenditure for each class of asset. The most common type of depreciation is the straight line and the double declining depreciation, which is a form of an accelerated method of depreciation.

In straight-line method, depreciation expense is distributed equally during the assets useful life. The annual depreciation expense is calculated by first subtracting the salvage value from the purchasing cost to get the net depreciation (Higgins, 2015). To calculate annual depreciation, an individual divides the total depreciation expense by the assets useful life. For instance, when calculating depreciation expense in an asset that has a value $100,000, a useful life of five years, and a salvage value of $20,000

Net depreciation= Purchasing cost- Salvage value

Net depreciation= $100,000- $20,000= $80,000

Annual depreciation = $80,000/5= $16,000

The double declining depreciation method is a form of accelerated depreciation in which most of the depreciation expense is recognized in the first few years of an asset's useful life. This method is reasonable and realistic than the simple depreciation because an assets' utility is mostly consumed in its first years. In addition, people prefer to recognize expenses at present than in future so that they may benefit from capital expense deduction when calculating their taxes. An asset is assumed to have zero depreciation once its book value is equal to its salvage value. The double declining depreciation is calculated by doubling the depreciation rate of the straight-line method. It then uses this rate on the remaining value of an asset in the subsequent years (Higgins, 2015).

An example of a double declining straight line calculation of an asset that has an initial value of $100,000, a useful life of five years, and a salvage value of $20,000

The rate of depreciation= Double that of straight-line method.

Depreciation rate= 2*(1/5)= 2/5 or 40%

Calculating depreciation

Year 1= 40%* $100,000= 40,000 (Depreciation)

Remaining value= $100,000-40,000= $60,000

Year 2= 40%* 60,000= 24,000 (Depreciation)

Remaining Value= $60,000- $24,000= $36,000

Year 3= 40%* 36,000= $14,400 (Depreciation)

Remaining Value= $36,000- $14,400= $21,600

Year 4 =40%* 21600= $8640

However, the item has a salvage value of $20,000

Therefore Maximum depreciation is= $21640- $20,000= $1640 (Depreciation)

Remaining value= $20,000

Net depreciation= Purchasing cost- Salvage value

Net depreciation= $100,000- $20,000= $80,000

Annual depreciation = $80,000/5= $16,000

Reference

Higgins, R. (2015). *Analysis of financial management* (11th Ed.). New York, NY: McGraw-Hill Publishers.