Depreciation and amortization

Business, Accounting

These are methods which are used to prorate the cost of a specific type of asset's life. One of the main principles of accrual accounting requires that an asset's cost be proportionally expensed based on the time period over which the asset was used. These methods are calculated by subtracting the asset's salvage value from original cost. Depreciation is defined as the allocation of the depreciable amount of an asset over its estimated economic useful life.

Provision for depreciation of fixed assets having a definite economic useful life, should be made by allocating the depreciable amount of an asset as fairly as possible to the periods expected to benefit from its use. In the definition the following terms means: Depreciable asset-these are assets expected to be used during more than one accounting period and have a limited economic useful life. Useful life-this is the period over which a depreciable asset is expected to be used by the enterprise.

Depreciable amount –this is the historical cost of the asset or other amounts substituted for historical cost in financial statement less estimated residual life. For example if a motor vehicle was bought for $1000 and sold three years later for $200 then the amount of depreciation is $1000-$200=$800. Amortization usually refers to spreading an intangible asset's cost over that asset's useful life.

For instance, you may agree to rent a building for 20 years. This is normally called a lease. When the years are finished the lease is worth nothing to you as it has finished. Whatever you paid for the lease is now of no value. A similar asset is where you buy a patent with complete rights so that only you are able to produce something. When the patent time has finished, it then has no value. The usual length of a patent is 16 years.