

# ACCOUNTANCY

## Chapter 7: Depreciation, Provisions And Reserves



# Depreciation, Provisions And Reserves

## Meaning of Depreciation

Depreciation means fall in book value of a depreciable fixed asset because of its wear and tear, passage/efflux of time, obsolescence or accident. It is charged on all fixed assets except land because of its infinite economic life.

### ❖ Characteristics of Depreciation

- Depreciation is decline in the book value of tangible fixed asset.
- It decreases only the book value of an asset and not the market value of an asset.
- It is a non-cash expense as it does not involve cash.
- It is permanent, gradual and continuous in nature.
- It is an expense and therefore is debited to the profit and loss account.
- It is the process of writing off the capital expenditure which has already been incurred over its useful life.
- It is a process of allocation of cost of an asset to its useful life span and not the process of valuation of asset.
- It is only used for tangible fixed asset and cannot be used for wasting and fictitious assets. For example, depletion of natural resources and amortisation of goodwill.

### ❖ Concepts Related to Depreciation

- **Depletion:** It is related to the extraction of natural resources such as quarries and mines which leads to decline in the availability of the quantity of asset or material.
- **Amortisation:** Writing off the cost of intangible assets such as trade mark, copyright and patents over its useful life is known as amortisation.
- **Obsolescence:** Obsolescence means decrease in the value of asset because of innovation or improved technology, change in taste or fashion or inadequacy of the existing asset because of the improved demand.

### ❖ Causes of Depreciation

- Use of asset i.e. wear and tear: There exists a normal wear and tear because of constant use of fixed assets which leads to fall in the value of the assets.
- Passage/efflux of time: Whether assets are used or not, with the passage of time, its effective life will decrease.
- Obsolescence: Because of new technologies, innovations and inventions, assets purchased today may become outdated by tomorrow which leads to the obsolescence of fixed assets.
- Accidents: An asset may lose its value because of mishaps such as a fire accident, theft or

by natural calamities and are permanent in nature.

#### ❖ Need for Providing Depreciation

- **To ascertain the true profit or loss:** True profit or loss can be ascertained when all the expenses and losses incurred for earning revenues are charged to profit and loss account. Assets are used for earning revenues and its cost is charged in the form of depreciation from profit and loss account.
- **To show true and fair view of the financial position:** If depreciation is not charged, assets will be shown at a higher value than their actual value in the balance sheet. Consequently, the balance sheet will not reflect true and fair view of financial statements.
- **To retain out of profit funds for replacement:** Unlike other expenses, depreciation is a non-cash expense. So, the amount of depreciation debited to the profit and loss account will be retained in the business. These funds will be available for replacement of fixed assets when its useful life ends.
- **To ascertain correct cost of production:** Depreciation on the assets, which are engaged in production, is included in the cost of production. If depreciation is not charged, the cost of production is underestimated which will lead to low selling price, and thus leads to low profit.
- **To comply with legal requirement:** To comply with the provisions of the Companies Act and Income Tax Act, it is necessary to charge depreciation.

#### ❖ The factors involved in providing depreciation are

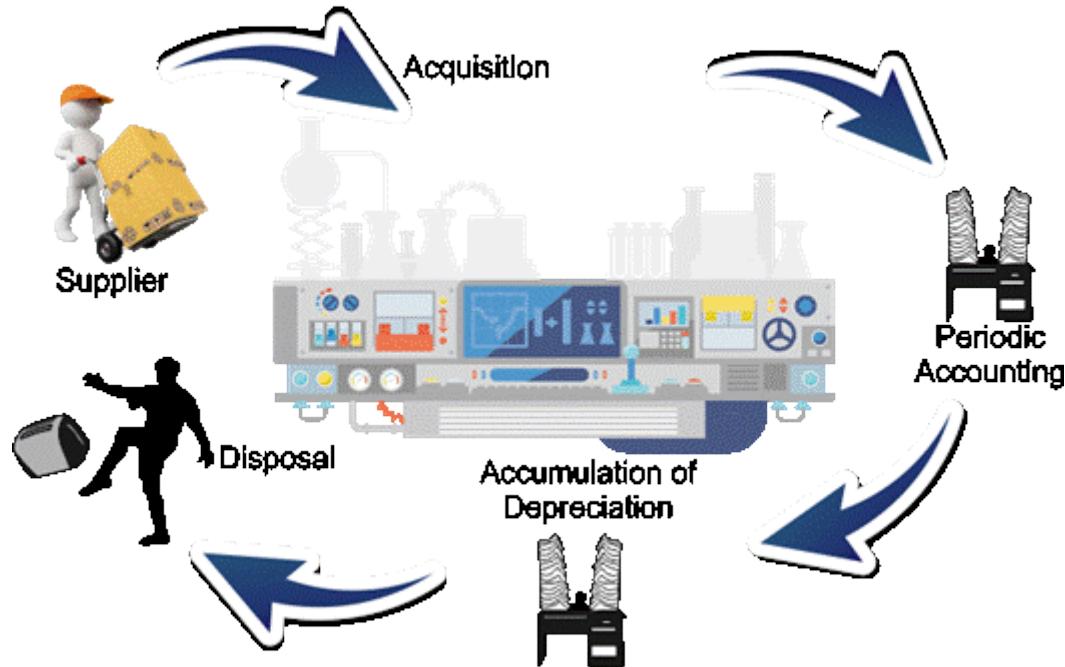
- **Historical (Original) cost of the asset:** The total cost of an asset is taken into consideration for ascertaining the amount of depreciation. The total cost of an asset includes all expenses incurred up to the point where the asset is ready for use such as freight expenses and installation charges.

Total cost =Purchase price+ Freight expenses+ Installation charges

- **Estimated net residual value:** It is estimated as the net realisable value of an asset at the end of its useful life. It is deducted from the total cost of an asset and the difference is written off over the useful life of the asset. For example, furniture acquired at ₹1,30,000 has its useful life estimated to be 10 years and its estimated scrap value is ₹10,000.

Depreciation per annum =  $1,30,000 - 10,000 / 10 \text{ years} = ₹12,000$

- **Estimated useful life:** Every asset has its useful life other than its physical life (in terms of number of years, units) used by a business. The asset may exist physically but may not be able to produce the goods at a reasonable cost. For example, an asset is likely to lose its useful value within 15 years; its useful life i.e. life for purpose of accounting should be considered as only 15 years.



## Methods of Recording Depreciation

In the books of account, following are the two methods of recording depreciation of fixed assets:

- When depreciation is charged or credited to the assets account.
- When depreciation is credited to provision for depreciation/accumulated account.

### When Depreciation is Charged or Credited to the Assets Account

In this method, depreciation is deducted from the asset value and charged (debited) to profit and loss account. Hence, the asset value is reduced by the amount of depreciation.

**Journal entries for recording under this method are as follows:**

**Journal**

| Purchase of an asset                                   |   |      |       |       |
|--|---|------|-------|-------|
| Date   | Particulars   | L.F. | Dr. ₹ | Cr. ₹ |
| 2016<br>1Jan   | Asset A/c<br>To Cash/Bank A/c<br>(Being the asset purchased and the cost of an asset including installation expenses and freight) | Dr.  |       |       |
| Following entries are recorded at the end of each year |   |      |       |       |
| 31Dec  | Depreciation<br>A/c To Asset A/<br>c<br>(Being the amount of depreciation charged)  | Dr.  |       |       |

|       |  |     |  |  |  |
|-------|--|-----|--|--|--|
| 31Dec | ProfitandLoss A/c<br>ToDepreciationA/c<br>(Being the depreciation amount transferred to profit and loss account) | Dr. |  |  |  |
|-------|--|-----|--|--|--|

In the balance sheet, asset appears at its written down value which is cost less depreciation charged till date. In this method, the original cost of an asset and the total amount of depreciation which has been charged cannot be ascertained from this balance sheet.

### ProfitandLoss Account

| Dr.   |                   |      |   |       | Cr.                |      |   |
|-------|-------------------|------|---|-------|--------------------|------|---|
| Date  | Particulars       | J.F. | ₹ | Date  | Particulars        | J.F. | ₹ |
| 31Dec | ToDepreciationA/c |      |   | 31Dec | ByGross Profit A/c |      |   |
| 31Dec | ToNetProfitA/c    |      |   |       |                    |      |   |

| Date | Liabilities | ₹ | Date | Assets            | ₹ |
|------|-------------|---|------|-------------------|---|
|      |             |   |      | Asset             |   |
|      |             |   |      | Less:Depreciation |   |

### When Depreciation is Credited to Provision for Depreciation Account

In this method, depreciation is credited to the provision for depreciation account or accumulated depreciation account every year. Depreciation is accumulated in a separate account instead of adjusting into the asset account at the end of each accounting period. In the balance sheet, the asset will continue to appear at the original cost every year. Thus, the balance sheet shows the original cost of the asset and the total amount of depreciation charged on asset.

**Journal entries for recording under this method are as follows:**

#### Journal

| Purchaseof an asset                                    |   |      |          |          |
|--|---|------|----------|----------|
| Date   | Particulars   | L.F. | Dr.<br>₹ | Cr.<br>₹ |
| 2016<br>1Jan   | AssetA/c<br>ToCash/Bank/VendorA/c<br>(Being the asset purchased and the cost of an asset including installation expenses and freight) | Dr.  |          |          |
| Following entries are recorded at the end of each year |   |      |          |          |
| 31Dec  | DepreciationA/c<br>ToProvision for Depreciation<br>A/c(Being the amount of depreciation charged)                                      | Dr.  |          |          |

|       |   |     |  |  |  |
|-------|---|-----|--|--|--|
| 31Dec | ProfitandLossA/c<br>ToDepreciationA/c<br>(Being the depreciation amount transferred to profit and loss account) | Dr. |  |  |  |
|-------|---|-----|--|--|--|

### ProfitandLoss Account

| Dr.       |                                 |      |   | Cr.   |             |      |   |
|-----------|---------------------------------|------|---|-------|-------------|------|---|
| Date      | Particulars                     | J.F. | ₹ | Date  | Particulars | J.F. | ₹ |
| 31De<br>c | To Provision<br>DepreciationA/c |      |   | 31Dec |             |      |   |

| Liabilities | ₹ | Assets                                    | ₹ |
|-------------|---|---|---|
|             |   | Asset<br>Less: Provision for Depreciation |   |

### Depreciation Account and Provision for Depreciation Account

| DepreciationAccount  | ProvisionforDepreciationAccount  |
|--|--|
| It is a nominal account  | It is a valuation account  |
| It will always have debit balance                                      | It will always have credit balance   |
| It is a temporary account  | It is a permanent account  |
| It is opened when an asset is shown at its written down value          | It is opened when an asset is shown at its original cost                   |
| It is charged against the assets account                               | It is not charged against the assets account                               |
| It will appear in the profit and loss account but not in balance sheet | It will appear in the balance sheet but not in the profit and loss account |

## Methods of Depreciation

### ❖ The two methods of depreciation are

- Fixed percentage on original cost or straight line method.
- Fixed percentage on diminishing balance or written down value method.

### ❖ Straight Line Method

According to this method, a fixed and equal amount is charged as depreciation for every accounting period during the life time of an asset. This method is based on the assumption of equal usage of time over asset's entire useful life. Hence, the amount of depreciation is same from period to period over the life of the asset.

### ❖ Depreciation amount can be calculated by using the following formula:

If the asset has a residual value at the end of its useful life, the amount to be written off

every year is as follows:

Depreciation = Cost of asset – Estimated net residual value / No. of years of expected life

If the annual depreciation amount is given then we can calculate the rate of depreciation as follows:

Rate of depreciation = Annual depreciation amount / Cost of asset \* 100

#### ❖ Advantages of Straight Line Method

- Simple to calculate the depreciation amount.
- Assets can be depreciated up to the estimated scrap value.
- Easy to understand the amount of depreciation.
- Every year, the same amount of depreciation is debited to profit and loss account, and hence the effect on profit and loss account will remain the same.

#### ❖ Disadvantages of Straight Line Method

- Interest on capital invested in assets is not provided in this method.
- Over the years, the work efficiency of assets decreases and repair expenses increases. Therefore, there is burden on the profit and loss account.
- Book value of the assets becomes zero but still the assets are used in the business.

#### ❖ Illustration

Pokemon and Brothers purchased a Machinery for ₹3,00,000 on April 01, 2014 and spent ₹40,000 for its installation. The salvage value of the machine after its useful life for 5 years, is estimated to be ₹5,000. Record journal entries for the year 2014-2015 and draw up Machine Account and Depreciation Account for first 2 years given that the depreciation is charged using straight line method if the books of accounts close on March 31 every year and the firm charges depreciation to the asset account.

#### BooksofPokemonandBrothersJournal Entries

| Date           | Particulars  | L.F. | Debit<br>₹ | Credit<br>₹ |
|----------------|--|------|------------|-------------|
| 2014           |  |      |            |             |
| Apr 1          | Machinery A/c<br>To Bank A/c<br>(Being machinery purchased for ₹3,00,000)      | Dr.  | 3,00,000   | 3,00,000    |
| 2014<br>Apr 1  | Machinery A/c<br>To Bank A/c<br>(Being expenses incurred on installation)      | Dr.  | 40,000     | 40,000      |
| 2015<br>Mar 31 | Depreciation A/c<br>To Machinery A/c<br>(Being depreciation charged on assets) | Dr.  | 67,000     | 67,000      |

|               |   |     |  |        |        |
|---------------|---|-----|--|--------|--------|
| 2015<br>Mar31 | Profit and Loss A/c<br>To Depreciation A/c<br>(Being depreciation debited to profit and loss account) | Dr. |  | 67,000 | 67,000 |
| 2016<br>Mar31 | Depreciation A/c<br>To Machinery A/c<br>(Being depreciation charged on assets)                        | Dr. |  | 67,000 | 67,000 |
| 2016<br>Mar31 | Profit and Loss A/c<br>To Depreciation A/c<br>(Being depreciation debited to profit and loss account) | Dr. |  | 67,000 | 67,000 |

### Machinery Account

| Dr.          |                |      |             |                        |                                       | Cr.  |                    |
|--------------|----------------|------|-------------|------------------------|---------------------------------------|------|--------------------|
| Date         | Particulars    | J.F. | Amount<br>₹ | Date                   | Particulars                           | J.F. | Amount<br>₹        |
| 2014         |                |      |             | 2015                   |                                       |      |                    |
| Apr1         | To Bank A/c    |      | 3,00,000    | Mar31                  | By Depreciation A/c                   |      | 67,000             |
| Apr1         | To Bank A/c    |      | 40,000      | Mar31                  | By Balance c/d                        |      | 2,73,000           |
|              |                |      | 3,40,000    |                        |                                       |      | 3,40,000           |
| 2015<br>Apr1 | To Balance b/d |      | 2,73,000    | 2016<br>Mar31<br>Mar31 | By Depreciation A/c<br>By Balance c/d |      | 67,000<br>2,06,000 |
|              |                |      | 2,73,000    |                        |                                       |      | 2,73,000           |
| 2016<br>Apr1 | To Balance b/d |      | 2,06,000    |                        |                                       |      |                    |

### Depreciation Account

| Dr.           |                  |      |             |               |                        | Cr.  |             |
|---------------|------------------|------|-------------|---------------|------------------------|------|-------------|
| Date          | Particulars      | J.F. | Amount<br>₹ | Date          | Particulars            | J.F. | Amount<br>₹ |
| 2015<br>Mar31 | To Machinery A/c |      | 67,000      | 2015<br>Mar31 | By Profit and Loss A/c |      | 67,000      |
|               |                  |      | 67,000      |               |                        |      | 67,000      |
| 2016<br>Mar31 | To Machinery A/c |      | 67,000      | 2016<br>Mar31 | By Profit and Loss A/c |      | 67,000      |
|               |                  |      | 67,000      |               |                        |      | 67,000      |

### Working Notes

Original Cost of Machinery = ₹3,00,000 + ₹40,000 = ₹3,40,000 Salvage value = ₹5,000

Life of asset= 5 years

$$\begin{aligned}\text{Depreciation per annum} &= \text{₹}3,40,000 - \text{₹}5,000/5 \\ &= \text{₹}67,000\end{aligned}$$

### Written Down Value Method

In this method depreciation is charged on the book value of the asset and the amount of depreciation reduces year after year. It implies that a fixed rate on the written down value of the asset is charged as depreciation every year over the expected useful life of the asset. The rate of depreciation is applicable to the book value but not to the cost of asset.

Rate of depreciation can be ascertained on the basis of cost, scrap value and useful life of the asset as follows:

$$R = 1 - n \sqrt{\frac{S}{C}} = 100$$

Where, R is the rate of depreciation in percent, n is the useful life of the asset; S is the scrap value at the end of useful life and C is the cost of the asset.

### Advantages of Written Down Value Method

- The profit and loss account of depreciation and repair expenses has same weightage throughout the useful life of asset because depreciation decreases with an increase in repair expenses.
- Since the benefits from asset keep on decreasing, the cost of asset is allocated rationally.
- This method is most favorable for those assets which require increased repairs and maintenance expenses over the years.
- This method is widely accepted under the Income Tax Act.

### Disadvantages of Written Down Value Method

- The value of assets can never be zero even though it is discarded.
- In this method, it is difficult to calculate depreciation.
- There is no provision of interest on capital invested in use of assets.

### Sale of an Asset

Sometimes an asset may be sold before the completion of its useful life because of obsolescence, inadequacy or for any other reason. In this case, there may be gain on sale of asset if the sale proceeds are greater than the written down value of the asset on the date of sale or loss on sale if the sale proceeds is lesser than the written down value of the asset on the date of sale. Then these profit or loss on sale of asset is transferred to profit and loss account.

Profit on Sale: Sale proceeds > Written Down Value of the Asset  
 Loss on Sale: Sale proceeds < Written Down Value of the Asset

Accounting entries for recording the sale of an asset are as follows:

**Journal**

| Date  | Particulars   | L.F. | Dr.<br>₹ | Cr.<br>₹ |
|---|---|------|----------|----------|
| <i>On the date of sale of an asset</i>  |   |      |          |          |
| 2016  | Cash/Bank A/c<br>To Asset A/c<br>(Being an Asset sold)  | Dr.  |          |          |
| <i>Provision for depreciation account is transferred to the Asset Account as it is no longer required to be taken forward.*</i> |   |      |          |          |
|   | Provision for Depreciation A/c<br>To Asset A/c<br>(Being the provision for depreciation transferred to Asset Account) | Dr.  |          |          |
| <i>In case of profit on sale</i>  |   |      |          |          |
|   | Asset A/c<br>To Profit and Loss A/c<br>(Being profit on sale of an asset transferred to Profit and Loss Account)      | Dr.  |          |          |
| <i>In case of loss on sale</i>  |   |      |          |          |
|   | Profit and Loss A/c<br>To Asset A/c<br>(Being loss on sale of an asset transferred to Profit and Loss Account)        | Dr.  |          |          |

\*Note: Only when the provision for depreciation account is maintained, entry will be passed.

### Disposal of an Asset

A new account is opened named Asset Disposal A/c at the time of sale of an asset. This account is opened in the ledger to calculate profit or loss on sale of an asset.

### Following journal entries required for preparation of Asset Disposal A/c

#### A. When provision for depreciation account is maintained.

**Journal**

| Date  | Particulars   | L.F. | Dr.<br>₹ | Cr.<br>₹ |
|---|---|------|----------|----------|
| <i>Gross value of the asset being sold is transferred to the Asset Disposal Account</i> |   |      |          |          |
| 2016  | Asset Disposal A/c<br>To Asset A/c<br>(Being the asset sold at original cost)   | Dr.  |          |          |
| <i>Amount of accumulated depreciation is transferred to the Asset Disposal Account</i>  |   |      |          |          |
|   | Provision for Depreciation A/c<br>To Asset Disposal A/c<br>(Being the accumulated depreciation transferred to Asset Disposal Account) | Dr.  |          |          |

|                                  |   |     |  |  |
|----------------------------------|---|-----|--|--|
| <i>Amount of sale proceeds</i>   |   |     |  |  |
|                                  | Cash/Bank A/c<br>To Asset Disposal A/c<br>(Being the sale value of the asset sold)  | Dr. |  |  |
| <i>In case of Profit on Sale</i> |   |     |  |  |
|                                  | Asset Disposal A/c<br>To Profit and Loss A/c<br>(Being profit on sale of an asset transferred to Profit and Loss Account) | Dr. |  |  |
| <i>In case of Loss on Sale</i>   |   |     |  |  |
|                                  | Profit and Loss A/c<br>To Asset Disposal A/c<br>(Being loss on sale of an asset transferred to Profit and Loss Account)   | Dr. |  |  |

### B. When provision for depreciation account is not maintained.

#### Journal

| Date  | Particulars   | L.F. | Dr. | Cr. |
|---|---|------|-----|-----|
| <i>Gross value of the asset being sold is transferred to the Asset Disposal Account</i> |   |      |     |     |
| 2016  | Asset Disposal A/c<br>To Asset A/c<br>(Being the asset sold at original cost)   | Dr.  |     |     |
| <i>Amount of accumulated depreciation is transferred to the Asset Disposal Account</i>  |   |      |     |     |
|   | Depreciation A/c<br>To Asset Disposal A/c<br>(Being the depreciation transferred to Asset Disposal Account)               | Dr.  |     |     |
| <i>Amount of sale proceeds</i>  |   |      |     |     |
|   | Cash/Bank A/c<br>To Asset Disposal A/c<br>(Being the sale value of the asset sold)  | Dr.  |     |     |
| <i>In case of Profit on Sale</i>  |   |      |     |     |
|   | Asset Disposal A/c<br>To Profit and Loss A/c<br>(Being profit on sale of an asset transferred to Profit and Loss Account) | Dr.  |     |     |
| <i>In case of Loss on Sale</i>  |   |      |     |     |
|   | Profit and Loss A/c<br>To Asset Disposal A/c<br>(Being loss on sale of an asset transferred to Profit and Loss Account)   | Dr.  |     |     |

### Difference between Straight Line and Written Down Value Method

| <b>Straight Line Method</b>  | <b>Written Down Value Method</b>  |
|--|---|
| Depreciation is calculated on the original cost of fixed asset   | Depreciation is calculated on the book value (i.e. original cost less depreciation) of fixed asset  |
| Amount of depreciation remains constant for all years  | Amount of depreciation keeps on decreasing year after year  |
| At the end of the useful life of an asset, the balance in the asset account will reduce to zero        | At the end of the useful life of an asset, the balance in the asset account will not reduce to zero |
| It is not accepted by Income Tax Law   | It is accepted by Income Tax Law  |
| It is suitable for assets which get completely depreciated on the account of expiry of its useful life | It is suitable for assets which require more and more repairs in the later stage of its useful life |
| Rate of depreciation is easy to calculate  | Rate of depreciation is difficult to calculate  |

### Illustration

On January 01, 2013, Vighneshwar Travels, purchased 2 Buses for ₹25,00,000 each. On July 01, 2016, one of the bus which was purchased on January 01, 2013 was sold for ₹9,50,000. Prepare Bus account and Provision for Depreciation account from the year 2013 to 2016, if depreciation is written off @10% p.a. on diminishing balance method. Books are closed on December 31 every year.

#### BooksofVighneshwarTravelsBusAc count

| Dr.   |              |             | Amount<br>₹ | Date             |               |  | Cr.              |
|-------|--------------|-------------|-------------|------------------|---------------|--|------------------|
|       | Date         | Particulars | J.F.        | Amount<br>₹      | Date          | Particulars                              | J.F.             |
| 2013  |              |             |             |                  |               |  |                  |
| Jan01 | ToBankA/c    |             |             | 50,00,000        | 2013<br>Dec31 | ByBalancec/d                             |                  |
|       |              |             |             | <b>50,00,000</b> |               |  | <b>50,00,000</b> |
| 2014  |              |             |             |                  |               |  |                  |
| Jan01 | ToBalanceb/d |             |             | 50,00,000        | 2014<br>Dec31 | ByBalancec/d                             |                  |
|       |              |             |             | <b>50,00,000</b> |               |  | <b>50,00,000</b> |
| 2015  |              |             |             |                  |               |  |                  |
| Jan01 | ToBalanceb/d |             |             | 50,00,000        | 2015<br>Dec31 | ByBalance c/d                            |                  |
|       |              |             |             | <b>50,00,000</b> |               |  | <b>50,00,000</b> |
| 2016  |              |             |             |                  | 2016          |  |                  |
| Jan01 | ToBalanceb/d |             |             | 50,00,000        | Jul01         | ByProvisionfor<br>depreciationA/c (Bus1) |                  |
|       |              |             |             |                  |               |  | 7,68,625         |
|       |              |             |             |                  | Jul01         | ByBank A/c (Sale)                        | 9,50,000         |
|       |              |             |             |                  | Jul01         | By Profit and Loss<br>A/c(Loss)          | 7,81,375         |
|       |              |             |             |                  | Dec31         | ByBalancec/d                             | 25,00,000        |
|       |              |             |             | <b>50,00,000</b> |               |  | <b>50,00,000</b> |

#### ProvisionforDepreciationAccount

| Dr. | Cr. |
|-----|-----|
|-----|-----|

| Date  | Particulars  | J.F. | Amount<br>₹ | Date  | Particulars       | J.F. | Amount<br>₹ |
|-------|--------------|------|-------------|-------|-------------------|------|-------------|
| 2013  |              |      |             | 2013  |                   |      |             |
| Dec31 | ToBalancec/d |      | 5,00,000    | Dec31 | ByDepreciationA/c |      | 5,00,000    |
|       |              |      | 5,00,000    |       |                   |      | 5,00,000    |
| 2014  |              |      |             | 2014  |                   |      |             |
|       |              |      |             | Jan01 | ByBalanceb/d      |      | 5,00,000    |
| Dec31 | ToBalancec/d |      | 9,50,000    | Dec31 | ByDepreciationA/c |      | 4,50,000    |
|       |              |      | 9,50,000    |       |                   |      | 9,50,000    |
| 2015  |              |      |             | 2015  |                   |      |             |
|       |              |      |             | Jan01 | ByBalanceb/d      |      | 9,50,000    |
| Dec31 | ToBalancec/d |      | 13,55,000   | Dec31 | ByDepreciationA/c |      | 4,05,000    |
|       |              |      | 13,55,000   |       |                   |      | 13,55,000   |
| 2016  |              |      |             | 2016  |                   |      |             |
| Jul01 | ToBus A/c    |      | 7,68,625    | Jan01 | ByBalanceb/d      |      | 13,55,000   |
|       |              |      |             | Jul01 | ByDepreciationA/c |      | 91,125      |
| Dec31 | ToBalancec/d |      | 8,59,750    | Dec31 | ByDepreciationA/c |      | 1,82,250    |
|       |              |      | 16,28,375   |       |                   |      | 16,28,375   |

### Working Notes:

| Years                    | Opening Balance | – | Depreciation   | = | Closing Balance |
|--------------------------|-----------------|---|----------------|---|-----------------|
| 2013                     | 25,00,000       | – | 2,50,000       | = | 22,50,000       |
| 2014                     | 22,50,000       | – | 2,25,000       | = | 20,25,000       |
| 2015                     | 20,25,000       | – | 2,02,500       | = | 18,22,500       |
| 2016                     | 18,22,500       | – | 91,125(6month) | = | 17,31,375       |
| Accumulated Depreciation |                 | = | 7,68,625       |   |                 |

|                             |           |
|-----------------------------|-----------|
| WDVs on July 01, 2016       | 17,31,375 |
| Less: Sale on July 01, 2016 | 9,50,000  |
| Loss on sale                | 7,81,375  |

### Provision and its Importance

Provision is an amount which is set aside by charging it to profit for the purpose of providing for any known liability or uncertain loss or expense. The amount of which cannot be determined with certainty is also referred to as provision. Few examples are provision for

depreciation, provision for doubtful debts and provision for discount on bad debtors.

The main objective of provision is to account all expenses and losses. Through the creation of provision account, the amount of liability, losses and expenses are estimated and accounted for the accounting

period. Therefore, the true profit and loss is ascertained, liabilities and assets are presented with correct values

#### ❖ Features

- It is an amount kept aside, out of income or profit, to meet the known liability.
- It is retention of profit made for the time being and specific reason such as known depletion in the value of the asset, anticipated loss occurred but the amount is not ascertained and a liability has been known to have arisen.
- At the time accounting, an appropriate amount of anticipated loss in the value of the asset or the liability is not ascertained.
- It is a charge to profit and loss account.

#### ❖ Importance of Provision

- **To meet anticipated losses and liabilities:** Provision is created to meet the anticipated losses and liabilities such as provision for doubtful debts, provision for discount on debtors and provision for taxation.
- **To meet known losses and liabilities:** Provision is created to meet known losses and liabilities such as provision for repairs and renewals.
- **To present correct financial statements:** To present a true and fair view of profit and financial statement, the business must maintain provision for known liabilities and losses.

Therefore, provision is necessarily to be created to ascertain the current income or profit.

Also, it is considered as a charge against revenue or profits.

#### Accounting Treatment

Provision is a charge against the profit which is debited in the profit and loss account. In the balance sheet, the amount of provision may be shown on the asset side by deducting from the relevant asset or on the liability side along with the current liabilities.

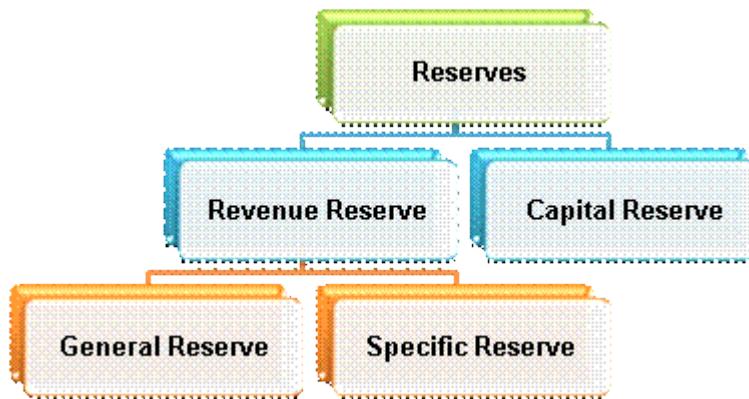
- Treatment on asset side— Provision for doubtful debts is deducted from the amount of sundry debtors and the provision for depreciation is deducted from the relevant asset.
- Treatment on liability side— Provision for repairs and charges are shown along with the current liabilities.

#### Reserves and its Importance

##### Reserves

Reserve is an amount set aside from the profit other than surplus which is retained by the business to meet future contingencies. It is an appropriation of profit and not a charge against profit, and therefore is shown in the profit and loss appropriation account.

### Types of Reserves



- ❖ **Revenue Reserve:** It is an amount set aside out of revenue profits for distribution of dividends. For example, general reserve, investment fluctuation fund, capital reserve and workmen compensation fund. It is not a charge against profit but it is appropriation of profit shown in the profit and loss account. It is beneficial for the smooth function of the business. The retention of profit in the form of reserves reduces the amount of profit to distribute among the business owners. This is further classified in to general reserve and specific reserve.
  - General reserve means a reserve which is not maintained for specific purpose. It helps to strengthen the financial status of the business. It is also known as free reserve and contingency reserve.
  - Specific reserve means a reserve which is maintained for specific purpose. For example, dividend equalisation reserve is created to maintain dividend rate. This reserve amount is utilised to maintain the rate dividend in the year of low profit. Likewise, the workmen compensation fund is maintained to provide claims of the workers, investment fluctuation fund is used at times of decline in the value of investment and debenture redemption reserve is used to provide funds for redemption of debentures.
- ❖ **Capital Reserve:** It is an amount set aside out of capital profits which is not available for distribution as dividend among the shareholders. It is used for writing capital losses/issue of bonus share in a company. Examples of capital reserves are
  - Profit prior to incorporation
  - Premium on issue of shares or debentures
  - Profit on redemption of debenture
  - Profit on forfeiture of share
  - Profit on sale of fixed assets
  - Capital redemption reserve

- Profit on revaluation of fixed assets and liabilities

### ❖ Importance of Reserves

- It strengthens the financial position of an enterprise
- It helps meet the purpose of future contingency
- It assists the expansion of business operation or to bring consistency in distribution of dividend.
- It creates reserves for investment allowance reserve

### Accounting Treatment

Reserves are not a charge against profit but are the appropriation of profits. Therefore, reserves are transferred to the debit side of profit and loss appropriation account. In the balance sheet, it is shown on the liability side under the heads of reserves and surplus.

### Provisions and Reserves

| Basis                                  | Provision   | Reserve  |
|--|---|--|
| <b>Basic Nature</b>                    | It is a charge against profit   | It is an appropriation of profit   |
| <b>Purpose</b>                         | It is created to meet specific liabilities or contingencies   | It is made for strengthening the financial position of the business. Some reserves are also mandatory under law. |
| <b>Accounting Treatment</b>            | It is recorded on the debit side of profit and loss account   | It is recorded on the debit side of the profit and loss appropriation account                                    |
| <b>Presentation in Balance Sheet</b>   | It can be shown either by way of deduction from the item on the assets side for which it is created or in the liabilities side along with the current liabilities | It is shown on the liabilities side after capital  |
| <b>Utilisation for Dividend</b>        | It cannot be utilised for dividend distribution   | It can be utilised for dividend distribution   |
| <b>Investment Outside the Business</b> | It is never invested outside the business   | It can be invested outside the business  |
| <b>Effects</b>                         | It reduces net profits  | It reduces only divisible profit   |

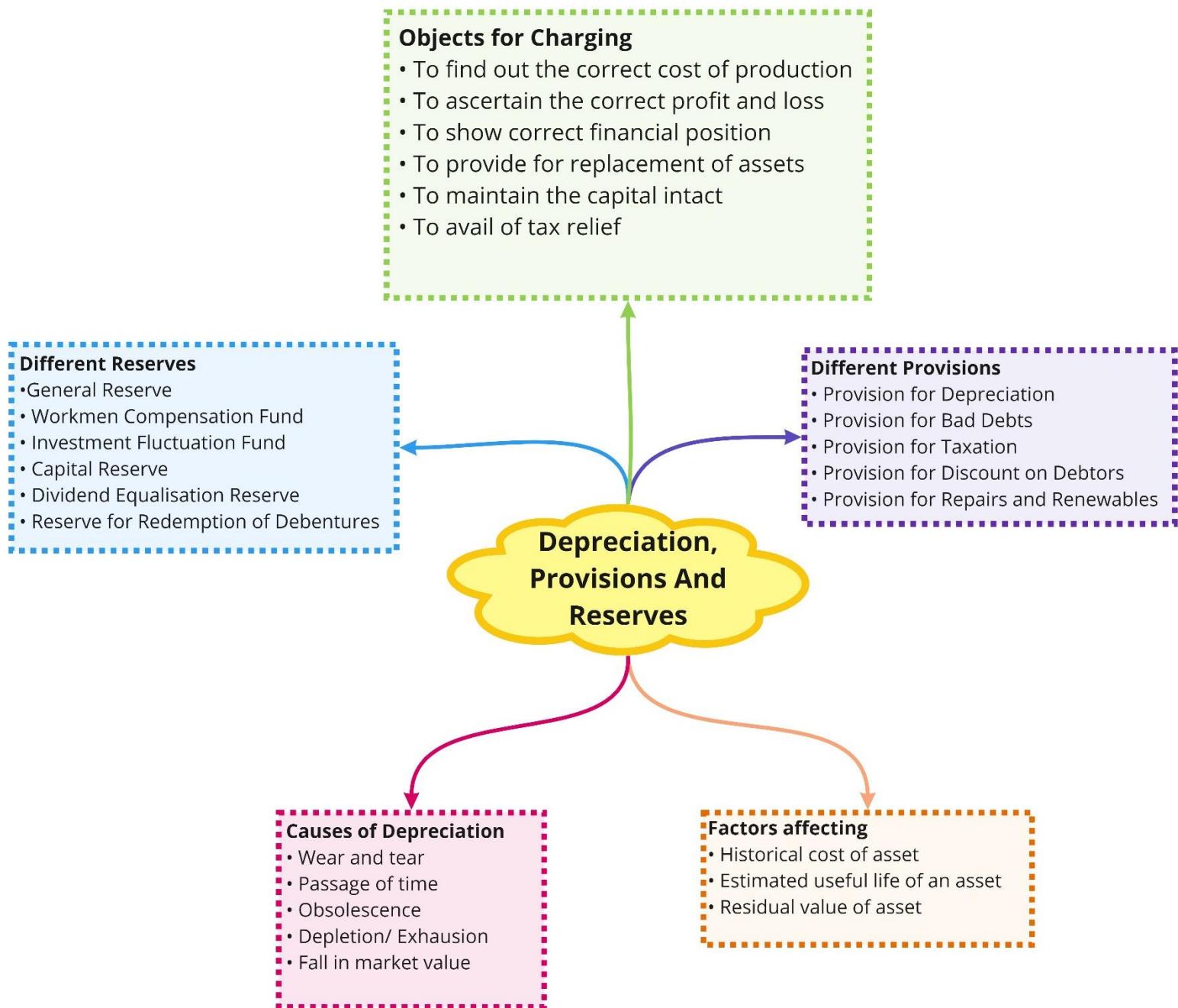
### Specific Reserve and General Reserve

| Basis                | Specific Reserve  | General Reserve   |
|----------------------|---|---|
| <b>Purpose</b>       | It is created for specific purposes   | It is not created for specific purposes   |
| <b>Available for</b> | It is not available for any future contingencies or expansion of business. It is utilised only for that purpose for | It is available for any future contingencies or expansion of business. It strengthens the |

|                 |   |   |
|-----------------|---|---|
|                 | which it is created.  | financial position.                     |
| <b>Examples</b> | Dividend equalisation reserve, debenture redemption reserve and development rebate reserves | Contingency reserve and general reserve |

## Revenue Reserve and Capital Reserve

| Basis                | Revenue Reserve   | Capital Reserve  |
|----------------------|---|--|
| <b>Source</b>        | It is created out of business profits   | It is created out of capital profits   |
| <b>Available for</b> | It is available for distribution of dividends without any precondition        | It is available for distribution of dividends only if the company fulfills certain conditions as per the Companies Act |
| <b>Purpose</b>       | It is for strengthening the financial position and for some specific purposes | It is for meeting capital losses or for a specific purpose of Company Act  |



## Important Questions

### Multiple Choice Questions-

Question 1. What Journal Entry will be passed: Value of asset being sold transferred to Asset Disposal Account?

- a) Asset Disposal A/c Dr
- b) Asset A/c Dr
- c) Asset A/c Dr
- d) Asset Sale A/c Dr

Question 2. Which method of depreciation suffers from the limitation of unequal burden on profit and loss account?

- a) Fixed Instalment Method
- b) Reducing Balance Method
- c) Depletion Method
- d) Annuity method

Question 3. Which method of charging depreciation is accepted by Income Tax Act?

- a) Written down value method
- b) Both Written down value method and Straight Line method
- c) Straight Line method
- d) None of the above

Question 4. Depreciation is a process of:

- a) Allocation of cost
- b) None of the above
- c) Valuation of asset
- d) Both valuation of asset and allocation of cost

Question 5. Depreciation is which of the following expenditure:

- a) Non-cash
- b) Both cash and non-cash
- c) Cash
- d) None of the above

Answer : Non-cash

Question 6. Which of the following statements is NOT true about Provisions?

- a) It is an appropriation of profit.
- b) It is a charge against profits.

- c) It is shown on the liability side of Balance sheet.
- d) It is discretionary as a matter of financial prudence.

Question 7. Which of the following statements is NOT true about Reserves?

- a) It is a charge against profits.
- b) It is an appropriation of profit.
- c) It is shown on the liability side of Balance sheet.
- d) It is discretionary as a matter of financial prudence.

Question 8. If the amount of any known liability cannot be determined with substantial accuracy:

- a) A provision should be created.
- b) A Contingent liability should be created.
- c) A definite liability should be created.
- d) A reserve should be created.

Answer : A provision should be created.

Question 9. Under which method the amount of depreciation remains same year after year?

- a) Fixed Installment Method
- b) Reducing Balance Method
- c) Annuity method
- d) Depletion Method

Question 10. As per the Original Cost method which is the correct formula for calculating Annual depreciation?

- a) Depreciation = Cost of asset Scrap value/ Estimated life of asset
- b) Depreciation = Scrap value - Cost of asset / Estimated life of asset
- c) Depreciation = Cost of asset - Market value / Estimated life of asset
- d) Depreciation = Cost of asset - Scrap value/ Market value of asset

### Very Short-

1. Define Depreciation.
2. What causes depreciation?
3. Give two objectives of Depreciation
4. State the two factors for determining the amount of depreciation
5. What is the scrap value or residual of an asset?
6. What is the formula of a depreciable cost?
7. Define Provisions.

8. State two characteristics of Provisions.

### Short Questions-

1. State two characteristics of Provisions.
2. Name the method that assumes that an asset should be depreciated more in the earlier years and less in later years of use.
3. Charging the whole cost of asset in the first year itself is not correct. Why?
4. Although, written down value method is based upon a more realistic assumption, it suffers from some limitations. Give any three such limitations.
5. Name and explain different type of reserves in details.

### Long Questions-

1. On 1st April 2014, merchant purchased furniture costing Rs.55,000. It is estimated that its life is 10 years at the end of which it will be sold Rs.5,000. Additions are made on 1st April 2015 and 1st October 2017 to the value of Rs.9,500 and Rs.8,400 (Residual values Rs.500 and Rs.400 respectively). Show the Furniture Account for the first four years, if Depreciation is written off according to the Straight Line Method.

### Case Study Based Question-

1. Read the following hypothetical text and answer the given questions: -

Arya Ltd. has a manufacturing plant in Delhi. On 1st July, 2021, Arya Ltd purchased a machine for ₹ 1,08,000 and spent ₹ 12,000 on its installation. At the time of purchase, it was estimated that the effective commercial life of the machine will be 12 years after which its salvage value will be ₹ 12,000. The machinery is such that the possibility of obsolescence is low and do not require much repair expenses with passage of time. The accounts are closed on 31st December every year.

#### Questions:

1. Which of the following method should be used by Arya Ltd. to charge depreciation?
  - (a) Written down value method
  - (b) Straight line method
  - (c) Insurance policy method
  - (d) None of the above
2. Why should depreciation be charged on the manufacturing plant of Arya Ltd?
  - (a) For matching of costs and revenue.
  - (b) To comply with law.
  - (c) To reflect true and fair financial position.
  - (d) All of the above
3. What is the original cost of the asset on which depreciation is to be charged?

- (a) ₹1,08,000
- (b) ₹12,000
- (c) ₹1,20,000
- (d) None of these

4. What is the amount of depreciation charged in the first year?

- (a) ₹9,000
- (b) ₹10,000
- (c) ₹4,500

5. Which of the following accounting standard should be followed by Arya Ltd. to charge depreciation?

- (a) Accounting Standard-7
- (b) Accounting Standard-6
- (c) Accounting Standard-8
- (d) Accounting Standard-9

2. Read the following hypothetical text and answer the given questions: -

On 1st April, 2017, X Ltd. purchased a machinery for ₹ 12,00,000. On 1st October, 2019 a part of the machinery purchased on 1st April, 2017 for ₹ 80,000 was sold for ₹ 45,000 and a new machinery at the cost of ₹ 1,58,000 was purchased and installed on the same date. The company has adopted the method of providing 10% p.a. depreciation on the diminishing balance of the machinery. X Ltd. maintains provision for depreciation and machinery disposal account. You are required to answer the following questions.

**Questions:**

1. What is the balance carried in the machinery account in March, 2018?
  - (a) ₹12,00,000
  - (b) ₹10,80,000
  - (c) ₹9,60,000
  - (d) None of these
2. Provision for depreciation will be shown as a current asset by X Ltd. in the balance sheet.
  - (a) True
  - (b) False
  - (c) Partially true
  - (d) Can't say
3. What is the accumulated depreciation on the machinery worth ₹ 80,000 that was

sold?

- (a) ₹8,000
- (b) ₹7,200
- (c) ₹18,440
- (d) None of these

4. Which of the following points need to be kept in mind when provision for depreciation account is maintained?
  - (a) Asset account continues to appear at its original cost year after year over its entire life
  - (b) Depreciation is accumulated on a separate account instead of being adjusted in the asset account at the end of each accounting period
  - (c) Both (a) and (b)
  - (d) None of the above
5. What is the gain or loss on the sale of machinery worth ₹ 80,000?
  - (a) ₹16,560 profit
  - (b) ₹16,560 loss
  - (c) ₹35,000 loss
  - (d) ₹35,000 profit

### Answer key

#### MCQ Answers-

1. Answer: Asset Disposal A/c Dr
2. Answer: Fixed Instalment Method
3. Answer: Written down value method
4. Answer: Allocation of cost
5. Answer: Non-cash
6. Answer: It is an appropriation of profit.
7. Answer: It is a charge against profits.
8. Answer: A provision should be created.
9. Answer: Fixed Installment Method
10. Depreciation = Cost of asset Scrap value/ Estimated life of asset

#### Very Short Answers-

1. Depreciation is defined as continuing or permanent decrease in the quantity, value, and quality of assets.

2. Ans. Depreciation is caused by
  - By constant use
  - By the expiry of a time
3. The two objectives of depreciation are
  - To determine true profit.
  - To create funds for replacement of assets.
4. Ans. The two factors for determining the amount of depreciation are
  - The total cost of the asset
  - The estimated useful life of the asset
5. Ans. The scrap value or residual of an asset is the estimated sale value of the assets at the end of its useful life.
6. Ans. Principal error can be represented by the following example:  
When a purchase of furniture is debited to purchase account instead of a furniture account.
7. Ans. Depreciable Cost = Cost of Asset – Scrap Value
8. The amount retained by way of providing for any unknown liability of which the amount cannot be determined with substantial accuracy.

## Short Answers-

1. The two characteristics of Provisions are.
  - Provision is an amount set aside to meet a future expense.
  - Provisions are recorded as a current liability in the balance sheet.
2. Ans. Written down value method. It is also known as Reducing Balance or Reducing the Installment Method or Diminishing Balance Method. Under this method, the depreciation is calculated at a certain fixed percentage each year on the decreasing book value commonly known as WDV of the asset (book value less depreciation).
3. Ans. Since this is not in conformity with the matching principle which requires revenues for a given period to be matched against expenses for the said period. The asset is used for more than one year. So the expenses of the depreciation also has to be charged for all those years, during which the asset is used.
4. Limitations of the Written Down Value Method  
Although this method is based upon a more realistic assumption it suffers from the following limitations
  - i. It does not take into consideration the interest on capital invested in the asset.
  - ii. It does not provide for the replacement of the asset on the expiry of its useful life.
  - iii. The formula to obtain the rate of depreciation can be applied only when there is a

residual value of the asset.

### 5. Ans. Type of Reserves

**Revenue Reserves:-** The reserves created from revenue profits which arise out of the normal operating activities of the business and are otherwise freely available for distribution as dividend are known as revenue reserves.

Revenue reserves can be classified into the following two types of reserves:-

**General Reserve:-** As suggested by the name the reserves which are not created for a specific purpose is general reserve. It strengthens the financial position of the business. It is also known as free reserve or contingency reserve.

**Specific Reserve:-** As suggested by the name, these are the reserves that are created for some specific purpose and can be utilized only for that purpose. e.g., Debenture Redemption Reserve, Workmen Compensation Fund, Investment Fluctuation Fund etc.

**Capital Reserve:-** The reserves which are created out of capital profits and are not available for distribution as dividend are known as capital reserve. These reserves are kept to prepare the company for any unforeseen event like inflation, instability, need to expand the business. Capital reserves can be used for writing off capital losses or issue of bonus shares in case of a company. Capital profit treated as capital reserves e.g. Premium on issue of securities, Profit on redemption of debentures, Profit on reissue of forfeited shares etc.

### Long Answers-

#### 1. Answer

| Dr.      |                    |    |        |          |                     |    | Cr.    |
|----------|--------------------|----|--------|----------|---------------------|----|--------|
| Date     | Particulars        | LF | Rs.    | Date     | Particulars         | LF | Rs.    |
| 01.04.14 | To Bank A/c – Cost |    | 55,000 | 31.03.15 | By Depreciation     |    | 5,000  |
|          |                    |    |        |          | By Balance c/d      |    | 50,000 |
|          |                    |    | 55,000 |          |                     |    | 55,000 |
| 01.04.15 | To Balance b/d     |    | 50,000 | 31.03.16 | By Depreciation A/c |    |        |
| 01.04.15 | To Bank A/c (f2)   |    | 9,500  |          | (5,000+900)         |    | 5,900  |

|          |                  |        |          |                     |  |        |
|----------|------------------|--------|----------|---------------------|--|--------|
|          |                  |        | 31.03.16 | By Balance c/d      |  | 53,600 |
|          |                  | 59,500 |          |                     |  | 59,500 |
| 01.04.16 | To Balance b/d   | 53,600 | 31.03.17 | By Depreciation A/c |  | 5,900  |
|          |                  |        | 31.03.17 | By Balance c/d      |  | 47,700 |
|          |                  | 53,600 |          |                     |  | 53,600 |
| 01.04.17 | To Balance b/d   | 47,700 | 31.03.18 | By Depreciation A/c |  |        |
| 01.10.17 | To Bank A/c (f3) | 8,400  |          | (5,900+400)         |  | 6,300  |
|          |                  |        | 31.03.18 | By Balance c/d      |  | 49,800 |
|          |                  | 56,100 |          |                     |  | 56,100 |
| 01.04.18 | To Balance b/d   | 49,800 |          |                     |  |        |

Depreciation = Total cost – scarp value / life of assets Total cost = Amount paid for machinery at the time of purchase. Scarp value = Sale value of machine at the time of sale Depreciation on 1st

Furniture = cost 55,000 & scarp value 5,000 so depreciation =  $\frac{55,000-5,000}{10}$

= Rs.5,000 per annum

Depreciation on 2nd Furniture = cost 9,500 & scarp value 500 so depreciation = Rs.  $\frac{9,500-500}{10}$

= Rs.900 per annum

Depreciation on 3rd Furniture = cost 8400 & scarp value 400 so depreciation = Rs.  $\frac{8,400-400}{10}$

= Rs.800 per annum

### Case Study Answer-

1. Answer:

1. (b) Straight line method
2. (c) To reflect true and fair financial position.
3. (c) ₹1,20,000
4. (c) ₹4,500

5. (b) Accounting Standard-6

2. Answer:

1. (a) ₹12,00,000
2. (b) False
3. (c) ₹18,440
4. (c) Both (a) and (b)
5. (b) ₹16,560 loss