
CHAPTER 7

DEPRECIATION, PROVISIONS AND RESERVES

❖ **Meaning**

Depreciation means reduction in the value of fixed asset due to: normal wear and tear associated with continuous use of the asset passage of time (even though the asset is not put to use due to weather, rains, etc.)

- technological obsolescence

❖ **Concept of Depreciation**

Purchase of fixed asset is considered as a capital expenditure and not an expense as its benefits can be availed over a period of time. Consequently, the cost of the asset is spread over the period of its useful life and due to continuous use of the fixed asset or with the passage of time, the value of the asset decreases. This reduction in the cost of the fixed asset is termed as depreciation.

According to the Matching Concept, depreciation is considered as an expense only to the extent of the decrease in the value of the asset during an accounting period. In other words, it refers to value of fixed asset consumed in the production process during an accounting period.

❖ **Depletion**

It refers to reduction in availability of natural resources due to extraction, mining and quarrying. It helps to ascertain reduction in product reserves of natural resources. In other words, it refers to the amount of natural resources used up during an accounting period.

❖ **Amortization**

It refers to writing-off the value of intangible assets like, copyright, patents, etc. over its useful life. It measures the amount of intangible assets used up during an accounting period.

❖ **Obsolescence**

It refers to the loss in the capital value of the existing fixed assets that is not physically worn out, due to advancement and appreciation of technology, scientific innovations and inventions, change in fashion, adoption of cost efficient production techniques.

❖ **Causes of Depreciation**

- Physical wear and tear
- Passage of time
- Expiration of legal rights
- Possibility of obsolescence



❖ Objectives for Charging depreciation

- Determining exact profit or loss
- Presenting true or fair view of the financial statements

❖ Factors/Basis for determining amount of depreciation:

- Original Cost of the Asset Estimated Scrap Value
- Estimated Life of the Asset

❖ Methods of providing/charging depreciation

There are several methods of charging depreciation but the popular methods are:

- Fixed Installment Method
- Diminishing Balance Method

❖ Formulas for calculating depreciation

- ***Fixed Installment Method/ Straight Line Method/ Original Cost Method***

Formula:

$$\text{Depreciation (p.a.)} = \frac{\text{Original cost} - \text{Scrap Value}}{\text{Estimate Life (in years)}}$$

Or,

$$\text{Depreciation (p.a.)} = (\text{Original Cost} - \text{Scrap Value}) \times \frac{\text{Rate of Depreciation}}{100}$$

$$\begin{aligned} \text{Original Cost of the Asset} = & \text{Purchase Price of the Asset} \\ & + \text{Expenses Incurred Before installation of the Asset} \\ & (\text{freight and installation charges}) \end{aligned}$$

Suitability: This method of charging depreciation is most suitable for those assets which have minimum repairs and renewals costs and comparatively short life, for example lease, copyrights, patents, etc.

- ***Diminishing Balance Method/ Reducing Balance Method/ Book Value Method***

Formula:

$$\text{Depreciation (p.a.)} = (\text{Opening Balance / Book Value of Asset}) \times \frac{\text{Rate of Depreciation}}{100}$$

$$\text{Rate of Depreciation (p.a.)} = \left(1 - \sqrt[n]{\frac{S}{C}} \right) \times 100$$

S represents scrap value of the asset

C represents cost of the asset

n represents the estimated life of asset in years



Suitability: This method of charging depreciation is suitable for those assets which have comparatively long life and need higher repairs cost in the later period of its life. The value of these assets does not reduce to zero or nil.

❖ **Methods of recording depreciation/accounting treatment of depreciation**

There are two ways of recording depreciation in the books of accounts.

- Depreciation is deducted from (credited to) the Asset Account/ *without maintaining Provision for Depreciation Account.*
- Depreciation is not deducted from (credited to) Asset Account/ *maintaining Provision for Depreciation Account.*

Journal Entries

Without Maintaining Provision for Depreciation Account		Maintaining Provision for Depreciation Account	
Asset A/c	Dr.	Asset A/c	Dr.
To Cash/Bank/Creditors A/c		To Cash/Bank/Creditors A/c	
(Asset purchased)		(Asset purchased)	
Depreciation A/c	Dr.	Depreciation A/c	Dr.
To Asset A/c		To Provision for Depreciation/	
(Depreciation charged)		Accumulated depreciation A/c	
		(Depreciation charged)	
Profit and loss A/c	Dr.	Profit and loss A/c	Dr.
To Depreciation A/c		To Depreciation A/c	
(Depreciation transferred to Profit and Loss Account)		(Depreciation transferred to Profit and Loss Account)	

- **Asset Account when depreciation is deducted from (credited to) Asset Account**

Asset Account

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	Balance b/d (Opening balance/book value)				Depreciation A/c		
	Cash/Bank/Debtors A/c (Purchase of Asset)				Bank/Cash/Creditors A/c (Sale of Asset)		
	Profit and Loss A/c (Profit on sale of asset, if any)				Profit and Loss A/c (Loss on sale of Asset, if any)		
					Balance c/d (Closing balance)		

- Asset Account when depreciation is not deducted from (credited to) Asset Account

Asset Account

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	Balance b/d Bank/Cash/Debtors A/c (Purchase price <i>plus</i> expense on purchase of asset)				*Accumulated Dep./ Provision for Dep. A/c (Depreciation of asset being sold, transferred from Asset Disposal Account)		
					Asset Disposal A/c (Original cost of asset sold, if it is sold through Asset Disposal Account)		
					Or Bank/Cash/Creditors A/c (Sale of Asset)		
	Profit and Loss A/c(Profit on sale of asset, if any)				Profit and Loss A/c (Loss on sale of asset, if any)		
					Balance c/d (Closing balance)		

***NOTE:** The amount of accumulated depreciation on the asset that is sold will be credited to the Asset Account only in the case, if Asset Disposal Account is not prepared.

Provision for Depreciation or Accumulated Depreciation Account

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	*Asset A/c (Accumulated depreciation on the asset sold, if it is transferred to the Asset Account)				Balance b/d		
	Or **Asset Disposal A/c (Accumulated depreciation on the asset sold, if it is transferred to Asset Disposal Account)				Depreciation A/c (Depreciation charged on all assets during an accounting period)		
	Balance c/d (Balancing figure)						



****NOTE:** The amount of accumulated depreciation on the asset that is sold will not be credited to the Asset Account, in fact will be debited to the Asset Disposal Account, if Asset Disposal Account is prepared.

- **Asset Disposal Account**

Asset Disposal Account can be prepared in both of the above methods, however it is not compulsory. It can be opened when asset is sold. The purpose of preparing Asset Disposal Account is to provide complete and clear view of all the transactions relating to the sale of the asset.

- *Asset Disposal Account when Provision for Depreciation Account is maintained.*

Asset Disposal Account

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	Machinery A/c (Purchase price <i>plus</i> expense incurred on purchase of asset)				**Provision for dep./ Accumulated dep. A/c (Accumulated depreciation of asset being sold)		
	Profit and Loss A/c (Profit on sale of asset, if any)				Bank/Cash/Debtors A/c (Sale price of Asset)		
					Profit and loss A/c (Loss occurred on sale of Asset, if any)		

- *Asset Disposal Account when depreciation is deducted from (credited to) the Asset Account*

Asset Disposal Account

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs	Date	Particulars	L.F.	Amount Rs
	Machinery A/c (Book value of asset sold)				Bank/Cash/Debtors A/c (Sale of asset)		
	Profit and loss A/c (Profit on sale of asset, if any)				Profit and Loss A/c (Loss on sale of asset, if any)		

❖ Provisions

Provisions are the amounts which are set off against profit or surplus to meet the known liabilities but the amount of these liabilities cannot be determined with certainty.

Examples of Provisions:

Provision for taxation

Provision for depreciation

Provision for doubtful debts

Provision for discount on debtors, etc.

❖ Reserves

Reserves are the amounts shown in the liabilities side of the Balance Sheet that are set off out of the profit or surplus. These reserves can be used for distribution of dividend, meeting contingent liabilities, investment outside the business and investment within the business to expand and strengthen the business.

❖ Accounting Treatment

Provisions		Reserves	
Profit and Loss A/c	Dr.	Profit and Loss Or Profit	
To Provision forA/c		and Loss Appropriation A/c	Dr.
(Provision made for)		To Reserve forA/c	
		(Amount transferred toReserve)	

❖ Types of Reserves:

- **Capital Reserves**

These reserves are made out of capital profit, for example, profit on sale of machinery transferred to capital reserve account.

- **Revenue Reserves**

These reserves are made out of revenue profit. There are two types of reserves, namely:

- *General Reserves*

These reserves are made out of revenue profit for general purpose.

- *Specific Reserves*

These reserves are made out of revenue profit for specific purpose, for example, Dividend Equilisation Reserve, Debenture Redemption Reserve, Capital Redemption Reserve, etc.



❖ **Difference between Provision and Reserves**

Point of Difference	Provision	Reserves
Source	It is made against profit	It is made out of profit
Conditions	It can be made even if the firm incurs loss	It is made only if the firm earns profit, after deducting all expenses and losses
Purpose	These are specific, i.e. can be used only for specific purpose.	These can be both specific as well as general
Liabilities	These are made to meet the known liabilities but the amount of these liabilities cannot be determined with certainty.	These are used for meeting contingent liabilities.

