# **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

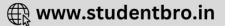
It refers to the loss in the capital value of the existing fixed assets that is not physically worn out, due to advancement and appreciation of technology, scientific innovations and inventions, change in fashion, adoption of cost efficient production techniques.

# Causes of Depreciation

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

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#### 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:

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

Or,

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

Original Cost of the Asset = Purchase Price of the Asset

+ Expenses Incurred Before installation of the Asset

(freight and installation charges)

*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:

Depreciation (p.a.) =  $\left(\text{Opening Balance / Book Value of Asset}\right) \times \frac{\text{Rate of Depreciation}}{100}$ Rate of Depreciation (p.a.) =  $\left(1 - \sqrt[n]{\frac{s}{C}}\right) \times 100$ 

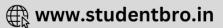
*S* represents scrap value of the asset

*C* represents cost of the asset

*n* represents the estimated life of asset in years

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*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 recoding 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.

| Without Maintaining Provision fo   | Maintaining Provision for Depreciation |  |                |
|--|--|--|----------------|
| Depreciation Account   | Account                                |  |                |
| Asset A/c<br>To Cash/Bank/Creditors A/c<br>(Asset purchased)   | Dr.                                    | Asset A/c<br>To Cash/Bank/Creditors A/c<br>(Asset purchased)   | Dr.            |
| Depreciation A/c<br>To Asset A/c<br>(Depreciation charged)   | Dr.                                    | Depreciation A/c<br>To Provision for Depreciation/<br>Accumulated depreciation A/c<br>(Depreciation charged) | Dr.            |
| Profit and loss A/c<br>To Depreciation A/c<br>(Depreciation transferred to Profit and Loss<br>Account) | Dr.                                    | Profit and loss A/c<br>To Depreciation A/c<br>(Depreciation transferred to Profit an<br>Account)             | Dr.<br>nd Loss |

## **Journal Entries**

# • Asset Account when depreciation is deducted from (credited to) Asset Account

#### Asset Account

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

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• Asset Account when depreciation is <u>not</u> deducted from (credited to) Asset Account

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

Asset Account

\*NOTE: The amount of accumulated depreciation on the asset that is sold will be *credited to the* 

<u>Asset Account</u> only in the case, <u>if Asset Disposal Account is not prepared</u>.

| Provision for De | preciation   | or Accumulated | <b>Depreciation Account</b> |
|------------------|--------------|----------------|-----------------------------|
| 1101101101120    | or condition | or recommended | 2 cpr celation recount      |

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

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**\*\***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. 0

|   |  |  |   |  |  | Cr.   |
|---|--|--|---|--|--|---|
|   |  | Amount   |   |  |  | Amount  |
| Particulars   | L.F.   | Rs   | Date  | Particulars  | L.F.   | Rs  |
| Machinery A/c   |  |  |   | <b>**</b> Provision for dep./  |  |   |
| (Purchase price plus expense                            |  |  |   | Accumulated dep. A/c   |  |   |
| incurred on purchase of                                 |  |  |   | (Accumulated depreciation  |  |   |
| asset)  |  |  |   | of asset being sold)   |  |   |
| Profit and Loss A/c(Profit<br>on sale of asset, if any) |  |  |   | Bank/Cash/Debtors A/c<br>(Sale price of Asset)   |  |   |
|   |  |  |   | Profit and loss A/c (Loss<br>occurred on sale of Asset, if<br>any)   |  |   |
|   |  |  |   |  |  |   |
|   | Machinery A/c<br>(Purchase price <i>plus</i> expense<br>incurred on purchase of<br>asset)<br>Profit and Loss A/c (Profit | Machinery A/c<br>(Purchase price <i>plus</i> expense<br>incurred on purchase of<br>asset)<br>Profit and Loss A/c (Profit | ParticularsL.F.RsMachinery A/c<br>(Purchase price plus expense<br>incurred on purchase of<br>asset) | Machinery A/c<br>(Purchase price <i>plus</i> expense<br>incurred on purchase of<br>asset)<br>Profit and Loss A/c (Profit | ParticularsL.F.RsDateParticularsMachinery A/c<br>(Purchase price plus expense<br>incurred on purchase of<br>asset)Image: State of the state of t | ParticularsL.F.RsDateParticularsL.F.Machinery A/c<br>(Purchase price plus expense<br>incurred on purchase of<br>asset)Image: State of Sta |

#### **Asset Disposal Account**

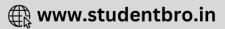
#### Asset Disposal Account when depreciation is deducted from (credited to) the Asset Account 0

#### **Asset Disposal Account**

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

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#### 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 to Reserve) |     |
|                      |     |                                 |     |

# 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:

o 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.

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# ✤ 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<br>loss   | It is made only if the firm earns<br>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<br>liabilities but the amount of these<br>liabilities cannot be determined with<br>certainty. | These are used for meeting contingent liabilities.                        |

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