Class-11 Accountancy
Chapter 5 – Depreciation Provision and Reserves

MEANING:

Depreciation means decrease in the value of fixed assets caused by use of asset, efflux of time or any other cause. Such annual loss in the value of the asset is like any other expense and require equitable spread over the period of the useful life of the asset.

According to Accounting Standard (AS) - 6 (Revised 1994)

"*Depreciation* is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is predetermined."

CHARACTERISTICS OF DEPRECIATION

(a) Depreciation is always a fall in the value of only fixed assets.

(b) This fall is always gradual.

(c) The fall is of permanent character and it cannot be recouped after words.

(d) The depreciation is a continuous process and it does not matter whether the assets was put to use during the period or not.

(e) Depreciation is the fall in the book value of the assets and not in market or exchange value.

(f) Depreciation is the result of the use of asset, passage of time and obsolescence.

Depletion:

Depletion is an accounting concept used most often in mining, timber, petroleum, or other similar industries. The depletion deduction allows an owner or operator to account for the reduction of a product's reserves

Amortisation

Amortization refers to expensing the acquisition cost minus the residual value of intangible assets (often intellectual property such as patents and trademarks or copyrights) in a systematic manner over their estimated useful economic lives so as to reflect their consumption, expiration, obsolescence or other decline in value as a result of use or the passage of time.

Obsolescence:

Due to technological developments, the asset in use may become out dated and loose a large part of its value. This fall may also be the result of changes in tastes and habits of customers, changes in the supply and location of material resources, etc. in other words, Obsolescence is a term used with the depreciation.

Abnormal Factors :

There are some abnormal factors which also lead to decrease the value of fixed assets. Examples of abnormal factors are : Loss by fire ; flood , earthquake , Theft etc.

CAUSES OF DEPRECIATION

(i) Wear and Tear due to Use of the
(ii) Accidents
(iii) Obsolescence's
(iv) Depletion
(v) Expiration of certain legal
(vi) Physical factors.
(vii) Inadequacy

NEED/OBJECTIVES/IMPORTANCE FOR PROVIDING DEPRECIATION

(i) *To ascertain true profits*
(ii) *To show true and fair view of financial position*
(iii) *To provide funds for replacement of assets*
(iv) *To keep the capital*
(v) To Know the Correct amount of income tax
(vi) Compliance with law
(vii) Matching costs and Revenue:

Factors affecting the depreciation

1. Original cost or Total cost of the Asset (Historical cost)
2. Estimated Scrap Value or Residual
3. Calculation of Depreciable cost or Amount to be written
4. Estimated life of an asset (Useful Life of an asset)

Straight line method :

Straight-line Method of depreciation is the simplest and most commonly used technique, Under this method the company forecasts the salvage value (Scrap value) of the asset at the end of the accounting period during which it will be used to generate revenues (useful life) and will expense a portion of original cost in equal increments over that period.

Diminishing Balance method :

It Provides a higher depreciation charge in the first year of an asset's life and gradually decreasing charges in subsequent years are called accelerated depreciation methods. This may be a more realistic reflection of an asset's actual expected benefit from the use of the asset: many assets are most useful when they are new. One popular accelerated method is the declining-balance method.

ACCOUNTING ENTRIES

(a) For writing off depreciation when provision for depreciation account is not maintained-

(i) Depreciation account.................Dr.
To asset account
(Being the entry for providing depreciation on asset)

(ii) Profit and loss account.............Dr.
To depreciation Account
(being the transfer of depreciation A/C to profit and loss A/C)
As a result of depreciation the asset appears at its reduced value in the balance sheet.

(b) In case provision for depreciation account is maintained.

(i) Depreciation account.................Dr.
To provision for depreciation account.
(Being the entry for providing depreciation on asset.)

(ii) Profit and loss account.............Dr.
To depreciation account.
(Being the transfer of depreciation A/C to profit and loss A/C)

Under this method, the asset account is not credited with the amount of depreciation; instead provision for depreciation account is credited. The asset appears in the balance sheet at its original cost and it changes only on its sale, addition or when discarded. Provision for depreciation account which effects accumulated depreciation to date is either shown on the liabilities side of the balance sheet or is deducted from the value of asset in the balance sheet. When an asset is sold, the depreciation to the date of sale is transferred from provision for depreciation account to the asset account, as a result of which the fixed asset is brought down to its written down value.

Provision for depreciation account…….Dr.
To asset Account

The difference between the sale price and the written down value of the asset is profit or loss on sale. In case the sale price exceeds the written down value of the asset, there shall be profit on sale.

The journal entry is :

(i) Cash /Bank account..................... Dr. Sale price
To asset account

(ii) Asset Account...............................Dr.
To profit and loss account Amount of profit

In case the sale of price of the asset is less than its written down value, there shall be a loss on sale.
The journal entry is:

Cash/Bank Account..............Dr...............Sale price

Profit and loss account.........Dr................Amount of loss.

To asset account ....Written down value.

Proforma **Depreciation A/c**

Date	Particulars	Amount	Date	Particulars	Amount
2009 March 31	By Asset A/c	→	2009 March 31	By Profit & loss A/c	→
2010 March 31	By Asset A/c	→	2010 March 31	By Profit & loss A/c	→
2011 March 31	By Asset A/c	→	2011 March 31	By Profit & loss A/c	→

Provision for Depreciation Account:

Journal Entries:

1. Depreciation A/c Dr.
   To Provision for Dep. A/c
   (being depreciation charged on asset)

2. Profit & Loss A/c Dr.
   To Depreciation A/c
   (Being Depreciation Transferred to Profit and Loss A/c)

Proforma:

Provision for Depreciation A/c

Date	Particulars	Amount	Date	Particulars	Amount
2010 March 31	By Balance c/d	→	2010 March 31	By Depreciation A/c	→
2011 March 31	By Balance c/d	→	2010 April1	By balance b/d	→
			2011 March 31	By Depreciation A/c	→
			2011 April 1	By Balance b/d	→

Asset Disposal Account

Most commonly this method is used when a part of the asset is sold and provision for depreciation account exists. Under this method a new account 'Asset Disposal account' is Maintained. This account may show debit or credit balance, Debit balance shows Loss and Credit Balance shows Profit. Asset disposal account is debited with the original cost of asset, being sold, and credited with amount of Provision for depreciation account. Amount of sale is also credited to Asset disposal account.

Following Journal entries are passed under this method:

1. Asset Disposal A/c Dr. (with the original cost of asset, being sold)
   To Asset A/c
2. Provision for Depreciation A/c Dr. (with the accumulated balance in provision for depreciation account)
   To Asset Disposal A/c
3. Bank A/c Dr. (with the net sales proceeds)
   To Asset Disposal A/c

Proforma:

Asset Disposal A/c

Date	Particulars	Amount	Date	Particulars	Amount
2010 Jan.1	By Asset A/c	→	2010 Jan. 1	By Provision for Dep. A/c	→
			Jan.1	By Bank (Sale)	→
	By Profit & Loss A/c (Profit on sale)	→	Jan.1	By Profit & Loss A/c (Loss on sale)	→
		→			→

Provisions & Reserves

<u>Meaning of Reserve</u> :

A sum set aside out of the Net Divisible profits and retained in order to provide for unexpected or unknown future losses or to strengthen the financial position of the business. Reserves may be created for: meeting the unforeseen contingencies or liabilities. Redemption of debentures etc.

Examples of Reserves :

a) Reserve for contingencies
b) General Reserve
c) Sinking fund reserve
d) Investment Fluctuation Reserve/fund
e) Reserve for improvement
f) Capital reserve
g) Debenture redemption reserve
h) Workmen's compensation Reserve/fund
i) Dividend equalization Reserve
j) Taxation Reserve
k) Staff welfare reserve

Characteristics or Features of Reserves

i) Reserves are the appropriation of profit ;

ii) Reserves are Helpful in improving the financial position of the business ;

iii) A business firm may invest the reserve outside ;

iv) Reserves are shown on the Liability side of the Balance Sheet ;

v) Creation of reserve is optional; it is not a legal necessity

Importance of Reserves

- Reserves are helpful in strengthening the financial position of the business.
- Reserve is a source of internal financing
- Reserves are helpful in expansion and growth of the business.
- Reserves are helpful in meeting unforeseen contingencies or future liabilities.
- Helpful in equalizing the rates of dividends.
- Helpful in redemption of liabilities such as redemption of debentures etc.
- Helpful in providing additional working capital and thus strengthening financial position of the business.

Capital Reserve :

Capital Reserve is created out of capital profits. These capital profits are not distributed among the shareholders and kept for utilization in some specific purposes such as writing preliminary expenses , providing premium on redemption of debentures etc.

Uses of Capital Reserve

a) Writing off preliminary expenses
b) Writing off discount on issue of share etc.
c) Premium on Redemption of debentures
d) Writing of capital losses
e) Issue of Bonus shares

Examples of Capital profits

a) Premium received on issue of Shares or debentures
b) Profit realized on the sale of fixed assets (if any)
c) Credit balance left on forfeiture account after reissuing the shares
d) Profit realized on Purchase of own debentures from the open market

e) Profit on redemption of debentures

General Reserve :

Reserve which is created to strengthen the general financial position of the business and not to meet any specific liability. It is also known as free reserve.

Specific Reserve :

This is a reserve which is created for a specific purpose or to meet a known loss such as depreciation, workmen compensation, doubtful debts etc.

Types of Specific Reserves

a) Dividend Equalization reserve/fund

b) Debenture Redemption Reserve

c) Investment fluctuation reserve/fund

d) Workmen's Compensation Fund

e) Reserve for the replacement of Asset

Secret Reserve:

This is a reserve which is not apparent on the face of the Balance sheet. The financial position of a business having secret reserve would be better than what appears from the balance sheet.

Secret Reserves can be formed in the following ways

1. Over depreciating assets
2. Under valuation of stock
3. Making an excessive provision for bad and doubtful debts
4. Incorrect allocation of expenditures in Capital and Revenue
5. Treating the contingent liability as Real liability

Advantages of Secret Reserves

a) Strengthen the financial position of a business by increasing the working capital
b) Bad time can be managed easily
c) Competitors cannot get the real picture of business
d) Easy to maintain the dividend rate over a period

Disadvantages of Secret Reserves

a) It doesn't give the correct picture of financial position of the business
b) Investors may feel cheated by the company

c) Shareholders may get confused; value of share may go down in the market.
d) Directors may get personal benefits.

Provisions

A Provision is the amount written off or retained by way of providing depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy.