CBSE Class 11 Accountancy
Revision Notes
Chapter-6 Depreciation, Provisions and Reserves

Learning Objectives
After studying this lesson, you should be able to:

- State the meaning and concept of depreciation.
- Explain the need and factors affecting depreciation.
- Explain the methods of charging depreciation.
- Show the Accounting Treatment of Depreciation.
- State the meaning of Provisions and Reserves.
- Differentiate between Provisions and Reserves.

Teaching Methods: Teachers are advised to use various examples from daily life in order to clear the concept of depreciation.

Depreciation Concept: Fixed assets are held on a long term basis and used to generate periodic revenue. That portion of assets, which is believed to have been consumed or expired to earn the revenue, needs to be charged as cost. Such an appropriate proportion of the cost of fixed assets is called Depreciation.
Business enterprises require fixed assets for their business operations such as furniture and fixtures, office equipments. plant and machinery, motor vehicles. land and building etc. In the process of converting Raw material into finished products, the fixed assets depreciate in value over a period of time, i.e. its useful life.
In other words, the process of allocation of the cost of a fixed asset over its useful life is known as depreciation

According to accounting standard - 6 (Revised) issued by the ICA
"Depreciation is a measure of wearing out, consumption or other loss of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes.
Depreciation is allocated so as to charge a fair proportion of the depreciable in each accounting period-during the expected useful life of the asset. Depreciation includes

amorization of assets whose useful life is predetermined.

Some Imporant Terms

i. **Obsolescence:-** When a fixed tangible assets become useless or unwanted due to new invention.
ii. **Amorization:-** The term amorization is used for writing off intangible assets such as goodwill, copyright, patents, etc.
iii. **Depletion:-** The term depletion is used in relation to decreasing the value of wasting assets or natural resources such as mines, oil wells, timber trees & fishing etc. due to the continue removal or extraction of things.

Need or objectives of providing Depreciation

1. **Ascertaining true profit or loss:**
    i. The true profit of an enterprise can be ascertained when all cost; incurred for the purpose of earning revenues have been debited to the profit and loss account.
    ii. Fall in the value of assets used in business operations is a part of the cost and should be shown in the profit and loss account of concerned accounting period.
    iii. Keeping this in view, depreciation must be debited to profit & loss account, since loss in value of fixed assets is also an expenses like other expenses.
2. **Presentation of True and Fair value of assets:** If depreciation is not provided, the value of assets shown in Balance sheet will not present the true and fair value of assets because assets are shown at the cost price but actual value is less than cost price of the assets.
3. **To ascertain the accurate cost of the Production:** Depreciation is an item of expense, the correct cost of production cannot be calculated unless it is also taken consideration. Hence, depreciation must be provided to ascertain the corn- recto cost of production.
4. **Computation of correct income tax:**
    i. Income tax of an enterprise is determined after charging all the costs of production.
    ii. If depreciation is not charged, the profits will be higher and the income tax will also be higher.
    iii. If depreciation is charged, Tax liability is reduced.
5. **Provision of funds and replacement of assets:** Depreciation is a non cash expense. So that amount of depreciation charged to profit and loss accounts is retained in business every year. These funds are available for replacement of the assets when its useful life is

over.

Methods of providing depreciation

1. Straight line method

i. This method is also known as ‘original cost method’.
ii. Under this method, depreciation is charged at fixed percentage on the original cost of the asset, throughout its estimated life.
iii. Under this method the amount of depreciation is uniform from year to year. That is why this method is also known as ‘Fixed Installment Method’ or Equal installment method’.
iv. The annual amount of depreciation can be easily calculated by the following formula:
Annual Depreciation $= \frac{\text{Original Cost - Estimated scrap value}}{\text{Estimated Life in year}}$

For examples: A firm purchases a machine for Rs. 2,25,000 on April 1, 2013. The expected life of this machine is 5 years. After 5 years the scrap of this machine would be realized Rs. 25,000. Under straight line method, the amount of depreciation can be calculated as under:
Annual Depreciation = $\frac{2{,}25{,}000-25{,}000}{5}$ = Rs. 40,000
Hence Rs. 40,000 will be charged every year as depreciation on this machine.

2. Diminishing balance method: Under this method, depreciation is charged as a fixed percentage on the book value of the asset every year. In first year the depreciation will be charged at the end of the year, on the total cost the asset.
Example: A machine is purchase for Rs. 2,00,000 on April 1. 2009. It is decided to charge depreciation on this machine @ 10% p.a. The amounts to depreciation for first four years by using both the methods **(Straight line method and Diminishing balance method)** as shown as under:

Year	Book Value	Dep. @ 10%	Book Vlaue	Dep. @ 10%
2009-10	20,000	2,000	20,000	2,000
2010-11	18,000 (20,000 - 2,000)	2,000	18,000 (20,000 - 2,000)	1,800
2011-12	16,000 (18,000 - 2,000)	2,000	16,200 (18,000 - 1,800)	1,620
2012-13	14,000 (16,000 - 2,000)	2,000	14,580 (16,200 - 1,620)	1,458

Hence, in Straight Line method, amount of depreciation is same but in Diminishing Balance Method amount of depreciation goes on decreasing every year. Depreciation can be recorded by crediting it to the Assets account.

Methods of Recording Depreciation

- First Method
  In this method one account is prepared :
  (i) Asset A/c
  In this case, each year, Depreciation is directly credited to the Asset A/c
  with the help of this entry:
  Depreciation A/c Dr
  To Asset A/c
- Second Method
  In this method two accounts are prepared :
  (i) Asset A/c
  (ii) Provision for Depreciation A/c
  In such case, ever year depreciation is directly credited to provision for Depreciation A/c. P.F.D. A/c shows the accumulated amount of depreciation to date.
  At the time sale of asset, the total accumulated depreciation of concern asset is transferred to the credit side of asset with the help of following entry.
  Accumulated Depreciation A/c or Prov. for Depreciation A/c Dr.
  To Asset A/c

Asset Disposal Account
Asset Disposal A/c is opened when an asset (partially or fully) is sold or disposed off. All entries related to sold asset are recorded in the asset disposal A/c. Methods of recording the entries in Asset Disposal A/c will depend on a fact whether a provision for depreciation A/c is maintained or not.

Format of Assets Disposal Account
When provision for Depreciation Account is maintained

To Asset A/c (Original Value)	-	By Provision for Depreciation A/c	-
		By Bank A/c	-

To Statement of profile	-	By Statement of profile	-
Loss (if loss)	-	Loss (if Profit)	-

When provision for Depreciation Account is not maintained

To Asset A/c (Original Value-Depreciation)	-	By Bank A/c	-
TO Statement of Profile &	-	By Statement of profile	-
Loss (if loss)	-	Loss (if profit)	-

Provisions

- Provision is to be made in respect of a liability, which is certain to be incurred, but its accurate amount is not known.
- It is charged in the Profit and loss Account on estimate basis. It Should be clearly understood that if the amount of a known liability can be determined with reasonable accuracy, it can not be a provision.

Notes: Provision is a charge against profits. It means provision has to be made irrespective of business enterprise is earning enough profits or incurring losses.

Examples of Provisions: Provision for Depreciation on assets, Provision for Repairs and Renewals of assets. Provision for Taxation, Provision for Discount on Debtors, Provision for Bad and Doubtful Debts.

Reserves

- Reserves are the amount set aside out of profits. It is an appropriation of profits and not a charge on the profits.
- The amount of profit retained is used in the business when difficult time comes. Since reserves are neither expenses nor losses, so these are not charged to profit & loss Account rather these are debited to Profit & Loss Appropriation Account which is prepared after Profit and Loss Account.
- Reserves are also known as ‘Ploughing Back of Profits’.
- Reserves are created to strengthening the financial positions of the business enterprise.

- Examples are General Reserves, Dividend Equalization Reserve etc.
- If the amount of reserve is invested outside the business then, it is called 'Reserve Fund'.
- Creation of reserve does not reduce the not profit but only reduced the divisible profits.

DIFFERENCE BETWEEN PROVISIONS AND RESERVES

Basis		Provision	Reserve
1.	**Meaning**	It is created to meet a known liability	It is created to strengthen the financial position of business enterprise.
2.	**Charge or Appropriation**	Provisions are charge against profits.	Reserve is an appropriation of profit.
3.	**Objective**	The object is to provide for known liability cannot be calculated accurately.	It is created to strengthen the financial position and to meet unforeseen liability
4.	**Effect on Profit & Loss A/c**	It is debited to the Profit Hence, profit is reduced.	Reserve reduces divisible profits.
5.	**Creation**	Provisions are to be created even if there are insufficient profits.	Reserve is created out of adequate profits only.
6	**Mode of creation**	Provisions are created by debiting the Profit & loss account.	It is created through Profit & Loss Appropriation Account.
7	**Investment**	It cannot be invested outside the business.	Reserve can be invested outside the business.
8	**Necessity**	Creation of provision is necessary as per law.	Its creation is not necessary. It is created as a matter of prudence.

Types of Reserves

- Revenue Reserves
    - General Reserves
    - Specific Reserves
- Capital Reserves

Revenue Reserves

Revenue Reserves are those reserves which are created by setting aside a par of the net profit of business. Since reserves represent undistributed profit of the company so they are available for declaration of dividend and distribution among shareholders. Revenue Reserves are of two types namely. (1) General Reserves (2) Specific Reserves.

1. **General Reserves:-** Those reserves which are created out of profit to meet out the unforseen contigencies is called general Reserves. They are termed as 'Free Reserves' or 'Contingency Reserves'. Creation of general reserve is optional. It is an appropriation of profit so it is made only if adequate profit is earned by the company. They are shown on liability side of the balance sheet under the head," Resere and surplus".
2. **Specific Reserves:-** These Reserves are created for specific purpose and can be utilised for that purpose only. Examples: Divindend Equalization Reserves, Debentures Redemption Reserve, workmen Compensation fund, Investment Fluctuation Reserves etc.
   Reserve fund:- If reserves are invested in outside securities, it is known as Resere fund.
   Capital Reserves:- The reserves created out of capital profits are known as capital Reserve. Such reserves, generally are not available for distribution as cash dividend among the share holders of a company.

Examples:-

i. Profit on sale of fixed assets.
ii. Profit on revaluation of assets and liabilities.
iii. Securities premium earned on issue of share or debentures.
iv. Profit on the purchase of running business.
v. Profit earned on forfeiture of shares.
vi. Profit on redemption of debentures.
vii. Profit prior to the incorporation of a company.

Capital profits can be used to write off capital losses and to issue fully paid up bonus shares among the equity share holders. However, company can declare dividend out of capital profits on the fulfilment of the following conditions.

i. Articles of Associations of a company permits the declaration of dividend out of such profile.
ii. Capital profits realised in cash.
iii. Profile remains after revaluation of assets and liabilities.