

DEPRECIATION, PROVISIONS AND RESERVES

Depreciation : An Introduction

Suppose you have purchased a car. After some time you noticed that if you want to sell this car, its value is less than its cost price. Similarly, the value of all fixed assets is decreased due to the passage of time and some other reasons. **The reduction in value of fixed assets is known as depreciation**

Expenditure on assets of the business like furniture, fixtures and fittings of the shop, motor vans, machines and equipments are neither expenditure on purchase of goods nor expenses.

Expenditure of this nature gives service to the business for many years and thus called fixed assets. Would you like to deduct the expenditure on the fixed assets from the profit of any one year? It would be wrong to do so since their benefit is enjoyed by the business for more than one year. The correct thing will be to distribute their cost over the years of their useful life to the business. The portion of the cost of fixed assets charged each year as expense is known as depreciation.

Learning Objectives

After studying this lesson you will be able to :

- State the meaning and concept of depreciation;
- Explain the causes of depreciation.
- Explain the methods of charging depreciation;
- Show the Accounting Treatment of Depreciation;
- State the meaning of Provision and Reserve;
- Differentiate between Provision and Reserve.

Teaching Methods :

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

'Provision for Depreciation Account' is to be taught through various exercises solved by both the Accounting Treatment of Depreciation, i.e. Charging Depreciation in Asset Account and Charging Depreciation in Provision for Depreciation Account.

Journal entries for creating Provision for Depreciation are also to be explained.

Depreciation : Concept

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. Depreciation is a part of the cost of a fixed asset which has expired :**

- On account of usage;
- Lapse of time.

In other words, the process of allocation of the cost of a fixed asset over its useful life is known as depreciation

Need or objectives of providing Depreciation :

1. Ascertaining true profit or loss :

- i. The true profit of an enterprise can be ascertained when all costs 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 expense 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 into consideration, Hence, depreciation must be provided to ascertain the correct 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 :

$$\text{Annual Depreciation} = \frac{\text{Original cost} - \text{Estimated scrap value}}{\text{Estimated life}}$$

For example :

A firm purchases a machine for Rs 2,25,000 on April 1, 2011. 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.

$$\text{Annual Depreciation} = \frac{2,25,000 - 25,000}{5} = 40,000$$

Hence, Rs 40,000 will be charged each 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 of the asset.

For example :

Year	Book Value (Rs)	Depreciation @ 10% (Rs)
2008-09	20,000	2,000
2010-10	20,000--2,000=18,000	1,800
2010-11	18,000--1,800=16,200	1,620
2011-12	16,200--1,620=14,580	1,458

Hence, in this method, **rate of depreciation is same but amount of depreciation** goes on decreasing every year. Therefore, this method is also known as 'written Down Value Method' and 'Reducing Installment Method'.

Illustration 1.

On January 1, 2008, a firm bought a machine for ₹ 90,000 and spent ₹ 6,000 on its installation and ₹ 4,000 on its carriage. It is decided to charge depreciation @ 10% on straight line method. Books are closed on December 31, each year. Show Machinery Account for the year 2008 to 2010.

Solution

Dr.				Machinery Account				Cr.			
Date	Particulars	J.F	₹	Date	Particulars	J.F	₹				
2008				2008							
Jan. 1	To Bank A/c		90,000	Dec 31	By Depreciation A/c		10,000				
Jan. 1	To Cash a/c		6,000	Dec 31	By Balance c/d		90,000				
Jan. 1	To Cash a/c		4,000								
			1,00,000				1,00,000				
2009				2009							
Jan. 1	To Balance b/d		90,000	Dec 31	By Depreciation A/c		10,000				
			90,000	Dec 31	By Balance c/d		80,000				
							90,000				
2010				2010							
Jan 1	To Balance b/d		80,000	Dec 31	By Depreciation A/c		10,000				
			80,000	Dec 31	By Balance c/d		70,000				
							80,000				

Illustration 2

On the basis of information given in Illustration 1, show Machinery Account for the year 2008 to 2010 if depreciation is charged @ 10% on diminishing balance method.

Solution :

Dr.

Machinery Account

Cr.

Date	Particulars	J.F	₹	Date	Particulars	J.F	₹
2008				2008			
Jan. 1	To Bank A/c		90,000	Dec 31	By Depreciation A/c		10,000
Jan. 1	To Cash a/c		6,000	Dec 31	By Balance c/d		90,000
Jan. 1	To Cash a/c		4,000				
			1,00,000				1,00,000
2009				2009			
Jan. 1	To Balance b/d		90,000	Dec 31	By Depreciation A/c		9,000
				Dec 31	By Balance c/d		81,000
			90,000				90,000
2010				2010			
Jan 1	To Balance b/d		81,000	Dec 31	By Depreciation A/c		8,100
				Dec 31	By Balance c/d		72,900
			81,000				81,000

Provisions :

1. Provision is to be made in respect of a liability, which is certain to be incurred, but its **accurate amount is not known**.
2. 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 a provision.

Note : Provision is a charge against profits it means provision has to be made irrespective of business enterprise is earning enough profit or loss.

Examples of Provisions :

- Provision for Depreciation of assets.
- Provision for Repairs and Renewals of assets.
- Provision for Taxation.
- Provision for Discount on Debtors.
- Provision for Bad and doubtful Debts.

Reserves :

1. 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.
2. 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.

3. Reserves are also known as 'Ploughing Back of Profits'. Reserves are created to strengthening the financial positions of the business enterprise. Examples are General Reserve, Dividend Equalization Reserve etc.
4. If the amount of reserve is invested outside the business then, it is called 'Reserve Fund'.
5. Creation of reserve does not reduce the net profit but only reduces the divisible profits. General Reserves and Specific Reserves Capital Reserves and Secret Reserves.

General Reserve :

If the purpose of creating the reserve is to meet any unforeseen contingency (Liability which is not known) in future, the reserve is called 'General Reserve'. These are retained for strengthening the financial position of the enterprise.

Specific Reserve :

Specific reserves are those reserves which are created for a specific purpose and can be utilized only for that purpose. 'Dividend Equalization Reserve' and 'Reserve for Replacement of Asset' are the examples of Specific Reserve.

Capital Reserve :

In addition to the normal profits, capital profits are also earned in the business from many sources. Reserves created out of capital profits which are.

1. **Not of recurring nature**
2. **Not readily available for distribution as dividend among the shareholders.**
3. **These reserve can be utilized for writing off capital losses.**

Capital Reserves may be created out of such profits as :

- i. Profit on sale of any fixed asset.
- ii. Profit on revaluation of assets.
- iii. Profit from forfeiture of shares,
- iv. Profit prior to incorporation of company.

Secret Reserve :

A secret reserve is created by undervaluing the fixed assets. Existence of secret reserve

1. Reduce the profits of the business enterprise and
2. Reduces its tax liability.
3. Secret reserve is secret in the sense that it is not known to the outsiders.
4. such reserves are created by showing the assets at a lower amount and liabilities at a higher amount.

Difference between Provisions and Reserve

Basis	Provision	Reserve
1. Meaning	It is created 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 appropriate of profit.
3. Objective	The object is to provide for known liability but cannot be calculated accurately.	It is created to strengthen the financial position and to meet unforeseen liability.
4. Effect on Profit	It is debited to the Profit & Loss Account. Hence, profit is reduced.	Reserve reduces divisible profits.
5. Creation	Provisions are to be created even if there are insufficient profit only.	Reserve is created out of adequate profits only.
6. Mode of creation	Provision 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. Creation of provision is necessary as per law.	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.

Points to Remember :

1. Fixed assets are those assets which are used for many years.
2. Depreciation means reduction in value of fixed assets.
3. Through accounting treatment of depreciation we can distribute the total cost of fixed assets over the years of their useful life.
4. There are two main methods of charging of charging depreciation : Straight Line Method and Diminishing Balance Method.
5. Depreciation is charged on fixed assets only and at the end of accounting period.
6. In Staight Line Method, depreciation is charged on original cost and the amount of depreciation remains same year after year.
7. In Diminishing Balance Method the amount of depreciation is reducing year after year because depreciation is charged on opening balance of the asset in every year.
8. In Staight Line Method, the book value of asset can be reduced to zero but in Diminishing Balance Method, the book value of asset can not be reduced to zero.
9. Provisions are made for known liabilities which can not be calculated accurately.
10. Reserves are created for strengthening the financial position of enterprise but can be created if adequated profits are available.