CBSE CLASS 11 ACCOUNTANCY

FINANCIAL ACCOUNTING PART-1

REVISION NOTES

CHAPTER-7

DEPRECIATION, PROVISIONS AND RESERVES

- **Depreciation**

  Depreciation may be described as a permanent, continuing and gradual shrinkage in the book value of fixed assets.

  Or

  Depreciation is gradual and permanent decrease in the value of an asset from any cause.

- **Features**

1. It is decline in the book value of fixed assets.
2. It is a continuing process.
3. It includes loss of value due to efflux ion of time, usage or obsolescence.
4. It is an expired cost and must be deducted before calculating taxable profit.

- **Causes of Depreciation**

1. Wear and tear due to use or passage of time.
2. Obsolescence.
3. Expiration of legal rights.
4. Abnormal factors.

- **Need or Objectives of Depreciation**

1. To ascertain the true profit or loss.
2. For consideration of tax.
3. To ascertain the true and fair financial position.
4. Compliance with legal provisions.

- **Factors or Basis for providing Depreciation**

1. Cost of asset.
2. Estimated net residual value.
3. Depreciable cost.
4. Estimated useful life.

- **Methods of calculating Depreciation**

1) **Straight line method (Fixed installment method):**

This method is based on the assumption of equal usage of time over asset's entire useful life. According to this method a fixed and equal amount is charged as depreciation in every accounting period during the life time of an asset. Depreciation amount can be calculated by the following formula:

Basis	**Straight line method**	**Written down value method**
Charging depreciation	On original cost of an asset	On book value of an asset
Amount of depreciation	Fixed year after year	Declines year after year
Recognition by income tax law	Not recognised	Recognised
Calculation	Easy to calculate	Difficult to calculate

$$\text{Depreciation} = \frac{\text{Cost of asset} - \text{estimated net residual value}}{\text{No. of years of expected life}}$$

2) **Written Down value method (Diminishing balance method):**

In this method depreciation is charged on the book value of tha asset. The amount of depreciation reduces year after year.

***Illustration*:** Soham purchased a machinery for Rs. 1,00,000 on 1st July, 2009. Another machine was purchased for Rs. 50,000 on 1st January, 2011. Depreciation is charged at 10% p.a. by straight line method. Accounts are closed on 31st December each year. Pass the necessary Journal entries, show machinery A/c and Depreciation A/c for the year 2009, 2010, 2011.

a) When Provision for depreciation a/c is not maintained.

b) When Provision for depreciation a/c is maintained.

***Solution*:**

a) When Provision for depreciation a/c is not maintained.

In The Books of Soham

Journal

Date	Particulars	LF	Debit Rs.	Credit Rs.
2009				
July 1	Machinery A/c Dr. To Bank A/c (Being machinery purchased for Rs. 1,00,000)		1,00,000	1,00,000
Dec 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation charged to machinery A/c)		5,000	5,000
Dec 31	Profit and Loss A/c Dr. To Depreciation A/c (Being depreciation amount transferred to Profit and Loss A/c)		5,000	5,000
2010				
Dec 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation charged to machinery A/c)		10,000	10,000

Dec 31	Profit and Loss A/c Dr. To Depreciation A/c (Being depreciation amount transferred to Profit and Loss A/c)		10,000	10,000
2011				
Jan 1	Machinery A/c Dr. To Bank A/c (Being machinery purchased)		50,000	50,000
Dec 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation charged to machinery A/c)		15,000	15,000
Dec 31	Profit and Loss A/c Dr. To Depreciation A/c (Being depreciation amount transferred to Profit and Loss A/c)		15,000	15,000

Dr. **Machinery A/c** **Cr.**

Date	**Particulars**	**LF**	**Rs.**	**Date**	**Particulars**	**LF**	**Rs.**
2009				2009			
	To Bank A/c (M-1)		1,00,000	Dec 31 Dec 31	By Depreciation A/c By Balance c/d		5,000 95,000
			1,00,000				1,00,000
2010				2010			
Jan 1	To Balance b/d		95,000	Dec 31	By Depreciation A/c By Balance c/d		10,000 85,000
			95,000				95,000
2011				2011			

Jan1 Jan 1	To Balance b/d To Bank A/c(M-II)		85,000 50,000	Dec 31	By Depreciation A/c (M-I – 10,000 + M-II – 5,000) By balance c/d		15,000 1,20,000
			1,35,000				1,35,000
2012				2012			
Jan 1	To balance b/d		1,20,000				

Dr. Depreciation A/c Cr.

Date	Particulars	LF	Rs.	Date	Particulars	LF	Rs.
2009				2009			
Dec 31	To Machinery A/c		5,000	Dec 31	By Profit and loss A/c		5,000
			5,000				5,000
2010				2010			
Jan 1	To Machinery A/c		10,000	Dec 31	By Profit and loss A/c		10,000
			10,000				10,000
2011				2011			
Jan 1	To Machinery A/c		15,000	Dec 31	By Profit and loss A/c		15,000
			15,000				15,000

b) When Provision for depreciation A/c is maintained.

In the Books of Soham

Journal

Date	Particulars	LF	Dr. Rs.	Cr. Rs.

2009				
July 1	Machinery A/c Dr. To Bank A/c (Being machinery purchased for Rs. 1,00,000)		1,00,000	1,00,000
Dec 31	Depreciation A/c Dr. To Provision for Depreciation A/c (Being depreciation charged to machinery A/c)		5,000	5,000
Dec 31	Profit and Loss A/c Dr. To Depreciation A/c (Being depreciation amount transferred to Profit and Loss A/c)		5,000	5,000
2010				
Dec 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation charged to machinery A/c)		10,000	10,000
Dec 31	Profit and Loss A/c Dr. To Depreciation A/c (Being depreciation amount transferred to Profit and Loss A/c)		10,000	10,000
2011				
Jan 1	Machinery A/c Dr. To Bank A/c (Being machinery purchased for Rs. 1,00,000)		50,000	50,000
Dec 31	Depreciation A/c Dr. To Provision for Depreciation A/c (Being depreciation charged to machinery A/c)		15,000	15,000

Dr. **Machinery A/c** **Cr.**

Date	Particulars	JF	Rs.	Date	Particulars	JF	Rs.
2009				2009			
Jul 1	To Bank A/c (M-I)		1,00,000	Dec 31	By Balance c/d		1,00,000
			1,00,000				1,00,000
2010				2010			
Jan 1	To Balance b/d		1,00,000	Dec 31	By Balance c/d		1,00,000
			1,00,000				1,00,000
2011				2011			
Jan 1 Jan 1	To Balance b/d To Bank A/c(M-II)		1,00,000 50,000	Dec 31	By balance c/d		1,50,000
			1,50,000				1,50,000
2012							
Jan 1	To balance b/d		1,50,000				

Dr. **Provision for Depreciation A/c** **Cr.**

Date	Particulars	JF	Rs.	Date	Particulars	JF	Rs.
2009				2009			
Dec 31	To Balance c/d		5,000	Dec 31	By Depreciation A/c		5,000
			5,000				5,000
2010				2010			
Dec 31	To Balance c/d		15,000	Jan 1	By Balance b/d By Depreciation A/c		5,000 10,000
			15,000				15,000
2011				2011			
Jan 1	To Balance c/d		30,000	Jan 1 Dec 31	By balance b/d By Depreciation		15,000

					A/c (M-I Rs. 10,000 + MII Rs. 5,000)		15,000
			30,000				30,000
				2012			
				Jan 1	By balance b/d		30,000

Dr. **Depreciation A/c** **Cr.**

Date	Particulars	JF	Rs.	Date	Particulars	JF	Rs.
2009				2009			
Dec 31	To Provision for Depreciation A/c		5,000	Dec 31	By Profit and loss A/c		5,000
			5,000				5,000
2010				2010			
Dec 31	To Provision for Depreciation A/c		10,000	Dec 31	By Profit and loss A/c		10,000
			10,000				10,000
2011				2011			
Dec 31	To Provision for Depreciation A/c		15,000	Dec 31	By Profit and loss A/c		15,000
			15,000				15,000

Sale of an Asset

(1) On the date of sale of an Asset

Cash / Bank A/c Dr.

To Asset A/c

(Being an Asset sold)

(2) If case of profit

Asset A/c Dr.

To Profit and Loss A/c

(Being profit on sale of an asset transferred to profit and Loss A/c)

(3) In case of loss

Profit and Loss A/c Dr.

To Asset A/c

(Being loss on sale of an asset transferred to profit and Loss A/c)

Provisions and Reserves

- **Provisions**

  Provision is an amount set aside by charging (debited) it in the profit and loss account, to provide for known liability the amount which cannot be determined accurately because they are not yet incurred. For example, Provision for Depreciation, Provision for Bad and doubtful debts etc.

- **Reserves**

  Reserves are the amount set aside out of profits. It is an appropriation of profits to strengthen the financial position of the business. For example, General reserve, Capital reserve etc.

- **Types of Reserves**

1) **General reserve:** It is the amount set aside out of profits for no specific purpose. It is available for strengthen the financial position or expansion of business.
2) Specific reserve: This is created for specific purpose and can be utilized only for that purpose.

3) **Secret reserve**: It is a reserve the existence or the amount of which is not disclosed in the balance sheet. It is also known as hidden reserve.

➢ **Distinguish between Reserves and Provisions**

Basis	**Reserves**	**Provisions**
Nature	It is an appropriation of profit.	It is charge of profit.
Purpose	It is created to strengthen the financial position of business.	It is created to meet known liability for which the amount is not determined.
Effect on taxable profit	It reduces the taxable profit.	It has no effect on taxable profit.
Distribution of dividend	It cannot be used for dividend distribution.	It can be used for dividend distribution.

➢ **Difference between revenue reserve and capital reserve**

Basis	**Revenue reserve**	**Capital reserve**
Source of creation	These reserves created from revenue profits.	These reserves created from capital profits.
Usage	These reserves can be used to give dividend to shareholders.	These reserves cannot be used for giving dividend to members.
Purpose	These reserves are created for meeting unforeseen losses.	It is used for writing off the capital losses.