

## UNIT-05

### Depreciation, Provisions and Reserves

#### Unit at a glance:

- Meaning of Depreciation
- Features of depreciation
- Causes of depreciation
- Need or objectives of depreciation
- Factors or basis for providing depreciation
- Methods of calculating depreciation
- Difference between straight line method and written down value method
- Methods of recording depreciation
- Sale of an asset
- Disposal of an asset
- Provisions and reserves
- Types of reserves

*“Depreciation is gradual and permanent decrease in the value of an asset from any cause.” – Carter*

#### **Introduction:**

Every fixed asset loses its value due to use or other reasons. This decline in the value of asset is known as depreciation.

#### **Meaning of Depreciation:**

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

#### **Features of Depreciation:**

- (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.





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

Dr.

Machinery A/c

Cr.

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

2011				2011			
Jan 1	To Balance b/d		85,000	Dec 31	By Depreciation A/c (M-I – 10,000 + M-II – 5,000)		15,000
Jan 1	To Bank A/c( M-II)		50,000	Dec 31	By balance c/d		1,20,000
			1,35,000				1,35,000
2012							
Jan 1	To balance b/d		1,20,000				

Dr.

Depreciation A/c

Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	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	L.F.	Dr. (Rs.)	Cr.(Rs.)
2009				
July 1	Machinery A/c		1,00,000	
	To Bank A/c			1,00,000





2011 Jan 1	To Balance c/d		30,000	2011 Jan 1	By balance b/d		15,000
				Dec 31	By Depreciation A/c (M-I Rs. 10,000 + M-II 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	J.F	Rs.	Date	Particulars	J.F	Rs.
2009 Dec 31	To Provision for Depreciation A/c		5,000	2009 Dec 31	By Profit and loss A/c		5,000
			5,000				5,000
2010 Dec 31	To Provision for Depreciation A/c		10,000	2010 Dec 31	By Profit and loss A/c		10,000
			10,000				10,000
2011 Dec 31	To Provision for Depreciation A/c		15,000	2011 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)

**Illustration – 2.** Rohan Ltd. purchased a Machinery on 1<sup>st</sup> May, 2009 for Rs. 60,000. On 1<sup>st</sup> July, 2010 it purchased another Machine for Rs. 20,000. On 31<sup>st</sup> March, 2011 it sold off the first machine purchased in 2009 for Rs. 39,000. Depreciation is provided at 20% on the original cost each year. Accounts are closed each year on 31<sup>st</sup> December. Show the Machinery account from 2009 to 2011.

Dr. Machinery A/c Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2009				2009			
May 1	To Bank A/c (M-I)		60,000	Dec 31	By Depreciation A/c		8,000
				Dec 31	By Balance c/d		52,000
			60,000				60,000
2010				2010			
Jan 1	To Balance b/d		52,000	Dec 31	By Depreciation A/c (M-I Rs. 12,000 + M-II Rs. 2,000)		14,000
Jul 1	To Bank A/c(M-II)		20,000	Dec 31	By Balance c/d (M-I Rs. 40,000 + M-II Rs. 18,000)		58,000
			72,000				72,000
2011				2011			
Jan 1	To Balance b/d		58,000	Mar 31	By Bank A/c (Sale)		39,000
Mar 31	To Bank A/c (M-III)		50,000	Mar 31	By Depreciation A/c(M-I)		3,000
Mar 31	To Profit and Loss A/c (profit on sale)		2,000	Dec 31	By Depreciation A/c (M-II Rs. 4,000 + M-III Rs. 7,500)		11,500
					By Balance c/d		

				Dec 31	(M-II Rs. 14,000 + M-III Rs. 42,500)		56,500
2012	To balance b/d		1,10,000				1,10,000
Jan 1			56,500				

Working notes:

Calculation of profit or loss on sale of machinery:

Book value as on 1 <sup>st</sup> January, 2011	Rs. 40,000
Less: Depreciation (60,000*20/100*3/12)	<u>Rs. 3,000</u>
Book value as on 31 <sup>st</sup> March, 2011	Rs. 37,000
Less: sale of machinery	<u>Rs. 39,000</u>
Profit on sale of machine	<u>Rs. 2,000</u>

**Illustration 3.** Suyashi Ltd. purchased on 1<sup>st</sup> January, 2009 a machinery for Rs. 36,000 and spent Rs. 4,000 on its installation. On 1<sup>st</sup> July, 2009 another machine purchased for Rs. 20,000. On 1<sup>st</sup> July, 2011, machine bought on 1<sup>st</sup> January, 2009 was sold for Rs. 12,000 and a new machine purchased for Rs. 64,000 on the same date. Depreciation is provided on 31<sup>st</sup> December @ 10% p.a. on the written down value method. Prepare machinery A/c from 2009 to 2011.

Solution:

Dr. Machinery A/c Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2009				2009			
Jan 1	To Bank A/c (M-I) (36,000 + 4,000)		40,000	Dec 31	By Depreciation A/c (M-I Rs. 4,000 + M-II Rs. 1,000)		5,000
July 1	To Bank A/c		20,000	Dec 31	By Balance c/d (M-I Rs. 36,000 + M-II Rs. 19,000)		55,000
			60,000				60,000

2010				2010			
Jan 1	To Balance b/d		55,000	Dec 31	By Depreciation A/c (M-I Rs. 3,600 + M-II Rs. 1,900)		5,500
				Dec 31	By Balance c/d (M-I Rs. 32,400 + M-II Rs. 17,100)		49,500
			55,000				55,000
2011				2011			
Jan 1	To Balance b/d		49,500	July 1	By Bank A/c (Sale)		12,000
July 1	To Bank A/c (M-III)		64,000	July 1	By Depreciation A/c(M-I)		1,620
				July 1	by Profit and Loss A/c (profit on sale)		18,780
				Dec 31	By Depreciation A/c (M-II Rs. 1,710 + M-III Rs. 3,200)		4,910
				Dec 31	By Balance c/d (M-II Rs. 15,390 + M-III Rs. 60,800)		76,190
			1,10,000				1,10,000
2012							
Jan 1	To balance b/d		76,190				

**Working notes:**

Calculation of Profit or loss on machine sold:

Book value of machine sold as on 31 <sup>st</sup> December, 2010	Rs. 32,400
Less: Depreciation (32400*10/100*6/12)	Rs. 1,620
Book value of machine sold as on 1 <sup>st</sup> July, 2011	Rs. 30,780
Less: sale of machine	Rs. 12,000
Loss on sale of machine	Rs. 18,780

**Disposal of an Asset:**

Under this method a new account is opened named 'Asset Disposal A/c' at the time of sale of an asset. Following journal entries required for preparation of Asset Disposal A/c

- (a) When provision for depreciation A/c is maintained.
- (1) Asset disposal A/c Dr.  
    To Asset A/c  
    (With the original cost of asset being sold)
  - (2) Provision for depreciation A/c Dr.  
    To Asset disposal A/c  
    (Transfer of accumulated depreciation)
  - (3) Bank A/c Dr.  
    To Asset disposal A/c  
    (With the net sales proceeds)
  - (4) Asset disposal A/c Dr.  
    To Profit and Loss A/c  
    (For profit on sale of the asset)
  - (5) Profit and Loss A/c Dr.  
    To Asset disposal A/c  
    (For loss on sale of an asset)
- (b) When provision for depreciation A/c is not maintained  
In this case replace entry no. 2 from above journal entries by passing following journal entry.
- Depreciation A/c Dr.  
    To Asset disposal A/c

**Illustration 4.** On 1<sup>st</sup> April, 2008, Jasmeet Ltd. purchased a machine for Rs. 12,00,000. On 1<sup>st</sup> October, 2010, a part of machine purchased on 1<sup>st</sup> April, 2008 for Rs. 80,000 was sold for Rs. 45,000 and a new machine was purchased for Rs. 1,58,000 on the same date. Company provides depreciation @10% p.a. on written down value method. Prepare necessary ledger accounts

- (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.

Dr.		Machinery A/c				Cr.	
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2008				2009			
Apr 1	To Bank A/c		12,00,000	Mar 31	By Depreciation A/c		1,20,000
				Mar 31	By Balance c/d		10,80,000
			12,00,000				12,00,000
2009				2010			
Apr 1	To Balance b/d		10,80,000	Mar 31	By Depreciation A/c		1,08,000
				Mar 31	By Balance c/d		9,72,000

2010			10,80,000	2010			10,80,000
Apr 1	To Balance b/d		9,72,000	Oct 1	By Bank A/c (Sale)		45,000
Oct 1	To Bank A/c		1,58,000	Oct 1	By Profit and Loss A/c (Loss on sale)		16,560
				Oct 1	By Depreciation A/c		3,240
				2011			
				Mar 31	By Depreciation A/c		98,620
				Mar 31	By Balance c/d		9,66,580
			11,30,000				11,30,000
2011							
Apr 1	To balance b/d		9,66,580				

(b) When provision for depreciation A/c is maintained.

Dr.				Machinery A/c		Cr.	
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2008				2009			
Apr 1	To Bank A/c		12,00,000	Mar 31	By Balance c/d		12,00,000
			12,00,000				12,00,000
2009				2010			
Apr 1	To Balance b/d		12,00,000	Mar 31	By Balance c/d		12,00,000
			12,00,000				12,00,000
2010				2010			
Apr 1	To Balance b/d		12,00,000	Oct 1	By Machine Disposal A/c		80,000
Oct 1	To Bank A/c		1,58,000	2011			
				Mar 31	By Balance c/d		12,78,000

2011			13,58,000				13,58,000
Apr 1	To balance b/d		12,78,000				

Dr. Provision for Depreciation A/c Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2009				2009			
Mar 31	To Balance c/d		1,20,000	Mar 31	By Depreciation A/c		1,20,000
			1,20,000				1,20,000
2010				2009			
Mar 31	To Balance c/d		2,28,000	Apr 1	By Balance b/d		1,20,000
				2010			
			2,28,000	Mar 31	By Depreciation A/c		1,08,000
							2,28,000
2010				2011			
Oct 1	To Machinery disposal A/c (8,000 + 7,200 + 3,240)		18,440	Apr 1	By Balance b/d		2,28,000
				Oct 1	By Depreciation A/c		3,240
2011				2011			
Mar 31	To Balance c/d		3,11,420	Mar 31	By Depreciation A/c		98,620
			3,29,860				3,29,860
				2011			
				Apr 1	By Balance b/d		3,11,420

Dr.

## Machinery Disposal A/c

Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2010				2010			
Oct 1	To Machinery A/c		80,000	Oct 1	By Provision for Dep. A/c		18,440
				Oct 1	By Bank a/c (sale)		45,000
				Oct 1	By Profit and loss A/c (Loss on sale)		16,560
			80,000				80,000

Working notes:

## Calculation of profit or loss on machine sold

Cost as on 1 <sup>st</sup> April, 2008	Rs. 80,000	
Less: dep. For 2008-09	Rs. <u>8,000</u>	
Book value as on 1 <sup>st</sup> April, 2009	Rs. 72,000	
Less: dep. For 2009-10	Rs. <u>7,200</u>	
Book value as on 1 <sup>st</sup> April, 2010	Rs. 64,800	
Less: dep. For 2010 ( $64,800 \times 10/100 \times 6/12$ )	Rs. <u>3,240</u>	(April to October)
Book value as on 1 <sup>st</sup> October, 2010	Rs. 61,560	
Less: sale of machine	Rs. <u>45,000</u>	
Loss on sale of machine	Rs. <u>16,560</u>	

## Calculation of depreciation on remaining machine

Old machine ( $9,72,000 - 64,800 = 9,07,200 \times 10/100$ )	Rs. 90,720	
New machine ( $1,58,000 \times 10/100 \times 6/12$ )	Rs. <u>7,900</u>	(October to March)
	Rs. <u>98,620</u>	

**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 can not 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**

- (a) **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.
- (b) **Specific reserve** – This is created for specific purpose and can be utilized only for that purpose.
- (c) **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**

<b>Basis</b>	<b>Reserves</b>	<b>Provisions</b>
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 can not be used for dividend distribution.	It can be used for dividend distribution.

### **Difference between revenue reserve and capital reserve**

<b>Basis of difference</b>	<b>Revenue reserve</b>	<b>Capital reserve</b>
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.

### **Questions**

- (1) Define Depreciation
- (2) State any two causes of Depreciation
- (3) Give two methods of providing Depreciation.
- (4) Give two examples of provisions.
- (5) What is meant by secret reserve?
- (6) Which method of depreciation assumes that an asset should be depreciated more in earlier years and less in the later years of use?
- (7) Depreciation cannot be provided in case of loss in a financial year. Comment.
- (8) Distinguish between provisions and reserves



### Numerical questions

- (1) Shyam Ltd. purchased a machinery on 1<sup>st</sup> May, 2009 for Rs. 60,000. On 1<sup>st</sup> July, 2010 it purchased another machine for Rs. 20,000. On 31<sup>st</sup> March, 2011, it sold the first machine purchased in 2009 for Rs. 38,500. Depreciation provided @ 20% p.a. on the original cost every year. Accounts are closed 31<sup>st</sup> December every year. Prepare machinery A/c for three years.  
[Profit on sale of machine Rs. 1,500; Balance of machine on 31<sup>st</sup> December, 2011 Rs. 14,000]
- (2) The following balances appear in the books of Raghav Ltd. As on 1<sup>st</sup> April, 2006:  
Machine A/c Rs. 5,00,000  
Provision for Depreciation A/c Rs. 2,25,000  
The machine is depreciated at 10% p.a. on the original cost. The accounting year being April to March. On 1<sup>st</sup> October, 2006, a machinery which was purchased on 1<sup>st</sup> July 2003 for Rs. 1,00,000 was sold for Rs. 42,000 and on the same date a new machine was purchased for Rs. 2,00,000. Prepare machine A/c and Provision for depreciation A/c for the year 2006-07.  
[Loss on sale of machine Rs. 25,500; Balance of Provision for dep. A/c Rs. 2,47,500; Balance of machine A/c Rs. 6,00,000]
- (3) Reema Ltd. Purchased on 1<sup>st</sup> on April, 2007 a machinery costing Rs. 30,000. It purchased another machinery on 1<sup>st</sup> October, 2007 costing Rs. 20,000 and on 1<sup>st</sup> July, 2008 costing Rs. 10,000.  
On 1<sup>st</sup> January, 2009 1/3<sup>rd</sup> of the machinery purchased on 1<sup>st</sup> April, 2007 became obsolete and was sold for Rs. 3,000.  
Show the machinery account assuming that the company's accounting year is a calendar year. It is being given that machinery was depreciated by fixed installment method at 10% p.a. What would be the value of Machinery A/c on 1<sup>st</sup> January, 2010?  
[Loss on sale of machine Rs. 5,250; Balance of machinery On 1<sup>st</sup> January, 2010 M-I (2/3) Rs. 14,500; M-II Rs. 15,500, M-III Rs. 8,500]
- (4) Ankit Ltd. Purchased a machine on 1<sup>st</sup> April 2006 for Rs. 1,80,000 and spent Rs. 20,000 on its installation.  
On 1<sup>st</sup> January, 2007, it purchased another machine for Rs. 2,40,000. On 1<sup>st</sup> July 2008 the machine purchased on 1<sup>st</sup> April, 2006 was sold for Rs. 1,45,000. On 1<sup>st</sup> October, 2008 another machine was purchased for Rs. 3,60,000.  
Prepare Machinery A/c from 2006 to 2008 after charging depreciation @ 10% p.a. by diminishing balance method. Accounts are closed 31<sup>st</sup> December each year.  
[Loss on sale machine Rs. 13,175; balance of machinery A/c Rs. 5,45,500 – M-II Rs. 1,94,400; M-II Rs. 3,51,000]
- (5) The following balance appears in the books of M/s. Palak Enterprise.
- |                 |                                |            |
|-----------------|--------------------------------|------------|
| 1st April, 2009 | Machinery A/c                  | Rs. 60,000 |
|                 | Provision for Depreciation A/c | Rs. 36,000 |
- On 1st April, 2009, they decided to dispose off a Machinery for Rs. 8,400 which was purchased on 1st April, 2005 for Rs. 16,000.  
You are required to prepare the Machinery A/c and Machinery Disposal A/c for 2009-10. Depreciation was charged at 10% on Original Cost Method.  
[Balance of machinery A/c on 31<sup>st</sup> March, 2010 Rs 44,000; Provision for Dep. A/c on 31<sup>st</sup> March, 2010 Rs. 34,000; Loss on sale of machinery Rs. 1,200]

- (6) A machinery was purchased for Rs.1,80,000 on 1<sup>st</sup> January, 2006. Depreciation was charged annually@ 10% on written down value method. 1/4<sup>th</sup> of this machinery was sold on 1<sup>st</sup> July, 2008 for Rs. 36,000. Prepare machinery A/c from 2006 to 2008, if the books are closed on 31<sup>st</sup> December each year.  
[Profit on sale of machinery Rs. 412; Balance of machinery A/c on 31<sup>st</sup> December, 2008 Rs. 1,01,150]

**Generally students commit the mistakes in these topics**

- Time factor in calculation of depreciation.
- Estimation of profit and loss at the time of sale of asset.
- At the time of maintain provision for depreciation A/c.
- Preparation of asset disposal A/c.

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