FIXED ASSETS

- Assets acquired not for resale.
- Help to earn revenue for more than 1 financial year.

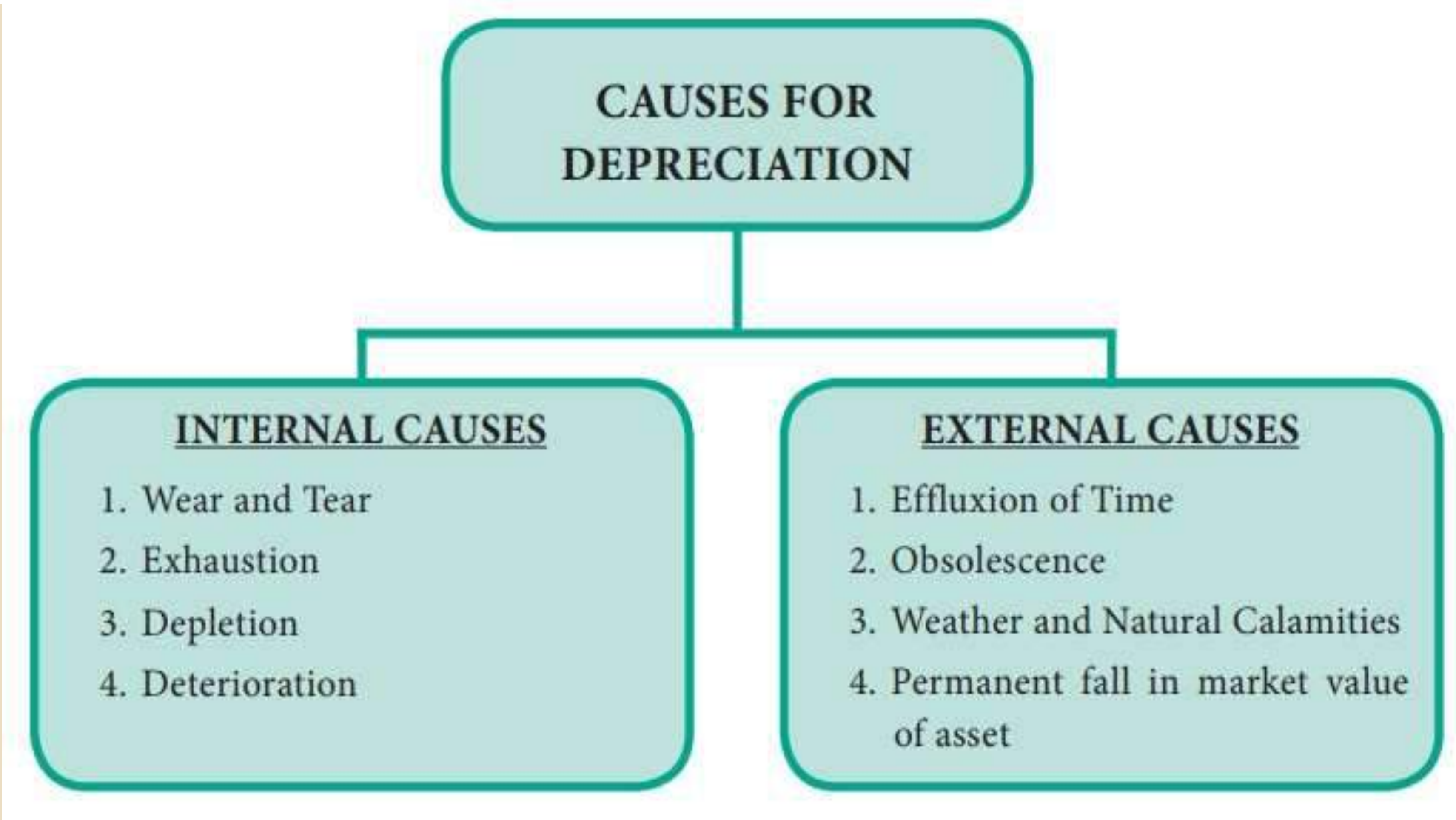
Examples :

- A printing machine in a printing company.
- A van in a courier service company.

DEFINITION OF DEPRECIATION

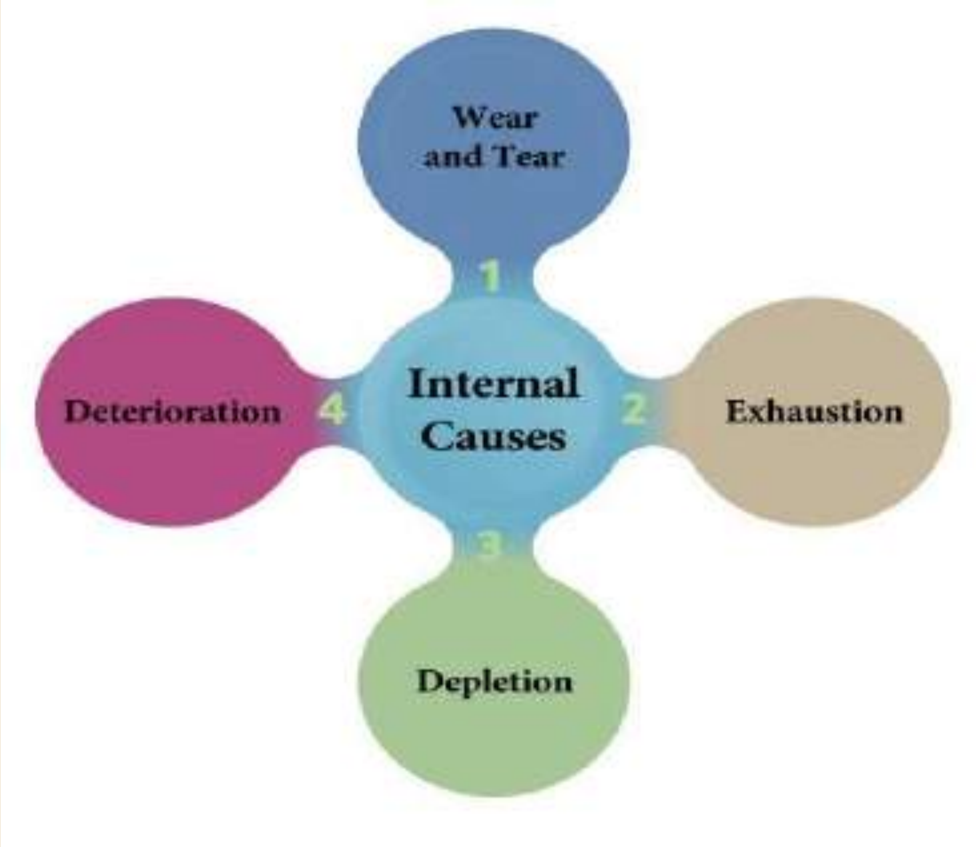
- Applies only to fixed assets.
- The whole cost of the fixed assets must be spread over its useful life.
- The portion of the cost allocated to a particular accounting period is charged as an expense against revenue (Matching principle).
- This portion of the cost is called Depreciation.

CAUSES OF DEPRECIATION



INTERNAL CAUSES

- Wear and tear, exhaustion, depletion, deterioration etc., causes depreciation on assets which are internal in nature.



INTERNAL CAUSES

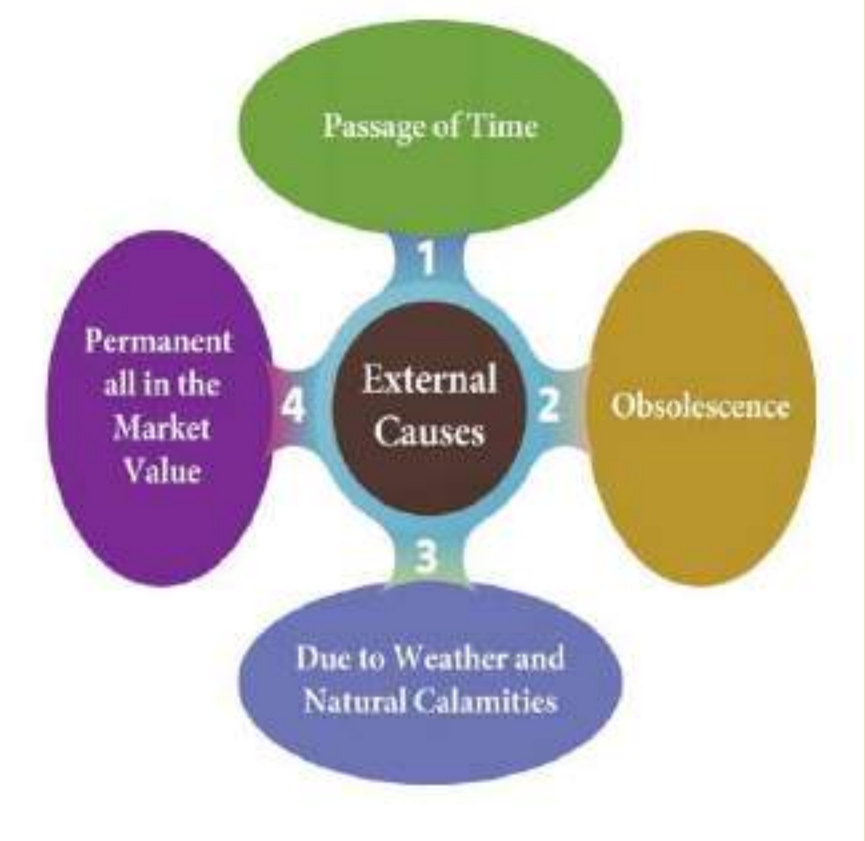
- **Wear and Tear:** The value of capital assets like plant, machinery, building etc. decrease in value due to constant use. The wear and tear of an asset depends on the usage of asset. For example, when machinery is used for three shifts the wear and tear will be greater than the machinery which is used on a single shift.
- **Exhaustion:** Certain assets like plantations and livestock loose their value with lapse of time as they are being used or consumed.

- **Depletion:** Natural resources such as mines, quarries and oil wells are of a wasting character and are called as wasting asset. These assets loose their value due to extraction of oil, depletion of minerals and metals.
- **Deterioration:** Deterioration means erosion in value of those assets which have a very short period of life. The fall in value of those assets refers to depreciation.

EXTERNAL CAUSES

- External factors which cause depreciation include passage of time , obsolescence, permanent fall in market value and due to weather and accidental calamities.

These factors are not connected to the inherent nature of the asset.



EXTERNAL CAUSES

- **Passage of Time:** For example, asset like lease hold property becomes valueless after the expiry of the period of lease.
- **Obsolescence:** for example, the demand for a product or service falls to such a level that it is no longer viable to continue with that product or service

- **Due to Weather and Natural Calamities:** Some assets lose in value when they are constantly exposed to rain, sun, wind etc. and certain assets decline in value when they are affected by certain natural calamities like flood, earth quake, fire etc.
- **Permanent fall in the Market Value:** Assets like investments lose in value due to permanent fall in market value of the asset. Such a fall in the price of an asset should be treated as depreciation.

METHODS OF DEPRECIATION

- Straight-Line
- Reducing Balance

STRAIGHT LINE METHOD

- A fixed asset is depreciated by an equal amount per year.
- Example: If an asset is depreciated by $1,000 in the first full year of usage, it will also be depreciated by Rs1,000 in the second year; Rs 1,000 in the third year and this continues annually until it is fully depreciated.

STRAIGHT LINE METHOD

- Advantages
  - Easy to calculate.
  - Easy to understand.
- Disadvantage
  - Assumes fixed asset gives same amount of service annually throughout its useful life.

STRAIGHT LINE METHOD

- A machine X costs Rs20,000 is expected to last 4 years. At the end of the 4th year, it can be sold for Rs 2,000 as scrap.
- Depreciation per year = (Original cost - Residual value)/ Expected useful life
- = (20,000 – 2000) 4
- = Rs 4,500

REDUCING BALANCE METHOD OF DEPRECIATION

- The amount of depreciation per year diminishes with every successive year.
- Example: - If an asset is depreciated by Rs 2,000 in the first full year of usage, it will be depreciated by less than Rs2,000 (eg Rs1,600) in the second year; and even less (eg Rs1,300) in the third year. This continues until it is fully depreciated.

- Advantage
  - REDUCING BALANCE METHOD •Disadvantages - Overall expenses (including repairs and maintenance) charged for the use of a fixed asset would be fairly constant.
- Disadvantages
  - Difficult to calculate.
  - Assets are always left with a small value at the end of useful life.

- A machine Y costs Rs10,000 is depreciated at 20% per annum on the reducing balance method. Show depreciation for the first 3 years.

	Depreciation	Net Book Value
Year 1	20 /100 X 10,000 = Rs2,000	Rs 10,000-2,000=8,000
Year 2	20/100 X 8,000 =Rs 1,600	Rs 8,000-1,600=6,400
Year 3	20/ 100 X 6,400 =Rs 1,280	Rs 6,400-1,280=5,120

Difference between SVM and WVM

Points of Difference	Straight Line	WDV
Meaning	In this method of depreciation, the cost of the asset is spread equally over the life years by writing off a fixed amount every year.	In this method of depreciation, a fixed rate of depreciation is charged on the book value of the asset, over its useful life.
Calculation of depreciation	On original cost	On written down value of the asset.
Annual depreciation charge	Remains fixed during the useful life.	Reduces every year
Value of asset	Completely written off	Not completely written off
Amount of depreciation	Initially lower	Initially higher
Impact of repairs and depreciation on P&L A/c	Increasing trend	Remains constant

Journal Entries of Depreciation

- For recording purchase of asset

  Asset A/c Dr.

  To Bank/Vendor A/c

- Following two entries are recorded at the end of every year
  - For deducting depreciation amount from the cost of the asset.

    Depreciation A/c Dr. (with the amount of depreciation)

    To Asset A/c

  - For charging depreciation to profit and loss account.

    Profit & Loss A/c Dr. (with the amount of depreciation)

    To Depreciation A/c

Question

- Salman and Usman Bros. acquired a machine on July 1, 2014 at a cost of ` 70,000 and spent ` 5,000 on its installation. The firm writes off depreciation @ 10% on straight line method. The books are closed on December 31 every year. Show the machinery and depreciation account for three years.

SOLUTION:

DEPRECIATION ACCOUNT

Date	Particulars	J.F.	Amount	Date	Particulars	J. F.	Amount
2014	To Machinery A/c		3,750	**2014**	By P & L A/c		3,750
Dec. 31	To Machinery A/c		3,750	Dec.31	By P & L A/c		3,750
2015	To Machinery A/c		3,750	**2015**	By P & L A/c		3,750
Dec. 31				Dec. 31			
2016				**2016**			
Dec. 31				Dec. 31			

MACHINERY ACCOUNT

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2014				**2014**	By Depreciation A/c		3,750
July 01	To Bank A/c		70,000	Dec. 31	By Balance c/d		71,250
July 01	To Bank A/c		5,000	Dec. 31			
			75,000				75,000
2015	To Balance		71,250	**2014**	By Depreciation A/c		7,500
Jan. 01	b/d			Dec. 31	By Balance c/d		63,750
			71,250				71,250
2016	To Balance		63,750	2014	By Depreciation A/c		7,500
Jan. 01	b/d			Dec. 31	By Balance c/d		56,250
			63,750				63,750

PROVISIONS AND RESERVE

MEANING OF PROVISIONS

The term "provision" means any amount written off or retained by way of providing depreciation , or retained by way of providing for any known liability .

Examples of Provisions

- Provision for depreciation
- Provision for bad and doubtful debts
- Provision for taxation
- Provision for discount on debtors
- Provision for repairs and renewals

Accounting Treatment for Provisions

Provision for Doubtful debts

Debtors may be of three types

- Good debts –Those debtors from whom collection of money is certain
- Bad debts – Those debtors from where collection of money is not possible and the amount of credit given is a certain loss.
- Doubtful debts - Those debtors who may pay but business firm is not sure about the collection of full amount from them.

JOURNAL ENTRY FOR CREATING PROVISION FOR DOUBTFUL DEBTS

For creating Provision

- **Profit and Loss A/c Dr.**

  To Provision for doubtful debts a/c

RESERVE

Any sum which is appropriated out of profit and loss appropriation account and is not meant to cover up liability, contingency, commitment,or reduction in the value of an asset is a reserve.

RESERVES

- Reserves are appropriations of profit to strengthen the financial position of the business.
- Reserve is not a charge against the profit,It is appropriation of profit

Examples of reserve

- General Reserve
- Workmen compensation fund
- Investment fluctuation fund
- Capital Reserve
- Dividend Equalization reserve
- Reserve for redemption of debenture

Difference between Reserve and Provision

Basis of difference	Provision	Reserve
1.Basic Nature	Charge against profit	Appropriation of profit
2.Purpose	It is created for a known liability or expense which is not certain	It is made for strengthening the financial position of the business
3.Effect on taxable profits	It reduces taxable profits	It has no effect on taxable profit
4.Presentaion in Balance Sheet	(i)by way of deduction from the asset (ii)In the liabilities side along with current liabilities	It is shown on the liabilities side after the capital
5.Element of compulsion	It must be made even if there are no profits	Reserve can not be created unless there are profits.
6.Use for the payment of dividend	It can not be used for dividend distribution	It can be used for dividend distribution

TYPES OF RESERVES

- General reserve
- Specific reserve
- Revenue reserve
- Capital reserve

General Reserve

- When the purpose for which the reserve is created is not specified, it is called general reserve. It is also termed as free
- reserve.

SPECIFIC RESERVE

Specific reserve is created for some specific purpose and can be utilized only for that purpose.

- Examples

(i).Dividend equalization reserve. This reserve is created to stabilize or maintain dividend rate.

(ii)Workmen compensation fund. It is created to provide for claims of the workers due to accident

(iii)Investment fluctuation fund. It is created to provide for claims of the workers due to accident

(iv)Debenture redemption reserve. It is created to provide funds for redemption of debentures

Revenue Reserve

- Revenue reserves are created from revenue profits which arise out of the normal operating activities of the business.

Examples

- General reserve
- Workmen compensation fund
- Investment fluctuation fund
- Dividend equalization reserve

CAPITAL RESERVE

These are created out of capital profits which do not arise from the normal operating activities. Such reserves are not available for distribution as dividend.

Examples of capital profits are: -

- Premium on issue of shares or debentures
- Profit on sale of fixed assets
- Profit on redemption of debentures

DIFFERENCE BETWEEN REVENUE RESERVE AND CAPITAL RESERVE

Basis of Difference	Revenue Reserve	Capital Reserve
Source of Creation	Created out of revenue profits.	Created out of capital profit.
Purpose	Created to strengthen the financial position.	Created for compliance of legal requirement s or accounting practices.
Usage	A specific revenue reserve can be utilized only for the earmarked purpose . A general reserve can be utilized for any purpose including distribution of dividend.	It can be utilized for specific purposes as provided in the law.

IMPORTANCE OF RESERVES

(i) Meeting a future contingency

(ii) Strengthening the general financial position of the business

(iii) Redeeming a long term liability like debentures etc.

SECRET RESERVE

Secret reserve is a reserve which does not appear in the balance sheet.It may also help to reduce the disclosed profits and also the tax liability .Secret reserves can be created in the following ways:-

- Undervaluation of Inventories
- Charging capital expenditure to profit and loss account
- Making excessive provision for doubtful debts

Thank You ....