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Class 11 commerce   Sub. ACT Date 15.02.2021

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Depreciation, Provisions and Reserves

Question 1:

What is Depreciation?

ANSWER:

Every business acquires fixed assets for its use in the business over a period of time. As the benefits of these assets can be availed over a long period of time, thus, due to their regular use, there occurs continuous wear and tear and consequently fall in their value. This fall in the value of fixed assets, due to their regular use or expiry of time is termed as depreciation.

A machinery costing Rs 1,00,000 and its useful life is 10 years; so, depreciation is calculated as:

$$\text{Annual Depreciation (p.a.)} = \frac{\text{Cost of Asset}}{\text{Expected or Estimated Life of Asset}}$$

$$\text{or, Annual Depreciation (p.a.)} = \frac{100000}{10} = \text{Rs } 10000$$

Question 2:

State briefly the need for providing depreciation.

ANSWER:

The needs for providing depreciation are given below.

1. **To ascertain true net profit or net loss−** Correct profit or loss can be ascertained when all the expenses and losses incurred for earning revenues are charged to Profit and Loss Account. Assets are used for earning revenues and its cost is charged in form of depreciation from Profit and Loss Account.

2. **To show true and fair view of financial statements−** If depreciation is **not** charged, assets are shown at higher value than their actual value in the Balance Sheet; consequently, the Balance Sheet does **not** reflect true and fair view of financial statements.

3. **For ascertaining the accurate cost of production−** Depreciation on plant and machinery and other assets, which are engaged in production, is included in the cost of production. If depreciation

is **not** included, cost of production is underestimated, which will lead to low sale price and thus leads to low profit.

4. **Distribution of dividend out of profit−** If depreciation is **not** charged, which leads to overestimating of profit and consequently more profit is distributed as dividend, out of capital instead of the profit. This leads to the flight of scarce capital out of the business.

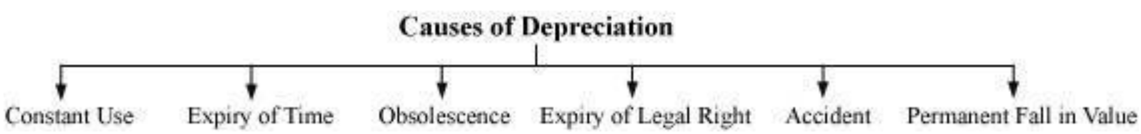
5. **To provide funds for replacement of assets−** Unlike other expenses, depreciation is **not** a cash expense. So, the amount of depreciation charged will be retained in the business and will be used for replacement of fixed assets after its useful life.

6. **Consideration of tax−** If depreciation is charged, then Profit and Loss Account will disclose lesser profit as to when the depreciation is **not** charged. This depicts reduced profit and thus the business will be liable for lesser tax amount.

Question 3:

What are the causes of depreciation?

ANSWER:



1. **Constant use−** Due to constant use of the fixed assets there exists normal wear and tear that leads to fall in the value of fixed assets.

2. **Expiry of time−** With the passage of time, whether assets are used or **not**, its effective life decreases. The natural forces like rain, weather, etc. lead to deterioration of the fixed assets.

3. **Obsolescence−** Due to the fast technological innovations and inventions today's assets may be outdated by tomorrow's sophisticated assets. This leads to the obsolescence of fixed assets.

4. **Expiry of legal rights−** If an asset is acquired for a specific period of time, then, whether the asset is put to use or **not**, its value becomes zero at the end of its useful life. For example, if a land is acquired for Rs 1,00,000 for 25 years on lease, then each year its value depreciates by $\frac{1}{25}$th of its gross value. At the end of the 25^{th} year, the value of the lease will be zero.

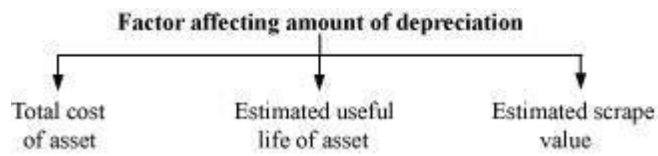
5. **Accident−** An asset may lose its value and damage may happen to it due to mishaps such as a fire accident, theft or a natural calamity. The loss due to accident is permanent in nature.

6. **Permanent fall in value−** Generally, we do **not** record fluctuations in the market price of the fixed assets in the books. However, if the fall in market price is permanent, it is accounted, which leads to a fall in the value of fixed assets in the books.

Question 4:

Explain basic factors affecting the amount of depreciation.

ANSWER:



1. **Total cost of asset−** The total cost of an asset is taken into consideration for ascertaining the amount of depreciation. The expenses incurred in acquiring, installing and constructing asset and bringing the asset to its usable condition are included in the total cost of asset.

2. **Estimated useful life−** Every asset has its useful life other than its physical life (in terms of number of years, units, etc.), used by a business. The useful life of an asset is considered to estimate the effective life of a fixed asset. For example, land has indefinite life; however, if business acquiress a piece of land on lease for 25 years, then the useful life of the piece of land is considered to be 25 years.

3. **Estimated scrap value−** It is estimated as the net realisable value or sale value of an asset at the end of its effective life. It is deducted from the total cost of an asset. For example, furniture is acquired at Rs 50,000 and its effective life is 10 years.

After 10 years, the furniture will be sold at Rs 10,000. So, depreciation is charged as:

$$\text{Depreciation (p.a.)} = \frac{(50{,}000 - 10{,}000)}{10} = \frac{40{,}000}{100} = \text{Rs } 4{,}000$$

Question 5:

Distinguish between straight line method and written down value method of calculating depreciation.

ANSWER:

Basis of Difference	Straight Line Method	Written Down Value Method
Basis for calculation	Depreciation is calculated on the original cost of an asset.	Depreciation is calculated on the reducing balance, i.e., the book value of an asset.
Amount of depreciation	Equal amount is charged each year over the effective life of the asset.	Diminishing amount of depreciation (on the written down value of asset) is charged each year over the effective life of the asset.

Book value of asset	Book value of the asset becomes zero at the end of its effective life.	Book value of the asset can never be zero.
Suitability	It is suitable for the assets like patents, copyright, land and buildings, etc., which have lesser possibility of obsolescence and lesser repair charges.	It is suitable for assets that needs more repair in the later years like, plant and machinery, car, etc.
Effect of depreciation and repair on profit and loss account	Unequal effect over the life of the asset, as depreciation remains same over the years but repair cost increases in the later years.	Equal effect over the life of the asset, as depreciation cost is high and repairs are less in the initial years but in the latter years the repair costs increase and depreciation cost decreases.
Recognition under Income Tax Act	It is **not** recognised under the income tax act.	It is recognised under the income tax act.