DEPRECIATION

The term depreciation refers to the reduction in or loss of quality or value of a fixed asset through wear and tear, effusion of time, obsolescence through technology and market changes or from any other cause. Depreciation takes place in case of all fixed assets with certain possible exceptions e.g. land and antiques etc, although the process may be invisible or gradual. Depreciation does take place irrespective of regular repairs and proper maintenance of assets. The word depreciation is closely related to the concept of business income. Unless it is charged against revenues, we cannot say that the business income has been ascertained properly. This is because of the fact that the use of long-term assets tends to consume their economic value and at some point of time these assets become useless. The economic value so consumed must be recovered from the revenue of the firm to have a proper measure of its income. Hence, the process of charging depreciation is the technique used by accountants for recovering the cost of fixed assets over a period.

Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. According to AS-6, depreciation is a measure of wearing out, consumption or other of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets. Depreciation includes amortization of assets whose useful life is pre determined.

The American Institute of Certified Public Accountants (AICPA) employed the definition as given below:

“Depreciation Accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of unit (which may be a group of assets) in a systematic and rational manner. It a process of allocation, not that of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year.

From the above definitions it is clear that each accounting period must be charged with a fair proportion of the depreciable amount of the asset, during the expected

useful life of the asset. Depreciable amount of an asset is its historical cost less the estimated residual value. Finally, it could be concluded that depreciation is a gradual reduction in the economic value of an asset from any cause.

Depreciation, Depletion, Obsolescence and Amortization:

The terms depreciation, depletion, obsolescence and amortization are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different types of assets. These terms have been described as follows:

Depreciation: Depreciation is concerned with charging the cost of man made fixed assets to operation (and not with determination of asset value for the balance sheet). In other words, the term depreciation is used when expired utility of physical asset (building, machinery, or equipment) is to be recorded.

Depletion: This term is applied to the process of removing an available but irreplaceable resource such as extracting coal from a coal miner or oil out of an oil well. Depletion differs from depreciation in that the former implies removal of a natural resource, while the latter implies a reduction in the service capacity of an asset.

Amortization: The process of writing off intangible assets is termed as amortization. The intangible assets like patents, copyrights, leaseholds and goodwill are recorded at cost in the books of account. Many of these assets have a limited useful life and are, therefore, written off.

Obsolescence: It refers to the decline in the useful life of an asset because of factors like (i) technological advancements, (ii) changes in the market demand of the product, (iii) legal or other restrictions, or (iv) improvement in production process.

CAUSES OF DEPRECIATION

The depreciation occurs because of the following:

1. **Constant use**: The constant use of assets results into their wear and tear, which in turn reduces their working capacity. Hence, a decrease in the value of assets may be seen due to reduced capacity. The value of assets like, machinery, furniture, etc., declines with the constant use of them.
2. **Passage of Time**: Many fixed assets lose their value with the passage of

time. This holds true in case of intangible fixed assets such as patents, copyrights, lease hold properties etc. The term amortization is generally used to indicate the reduction in the value of such assets.

3. Depletion: Depletion also causes decline in the value of certain assets. This is true in case of wasting assets such as mines, oil wells and forest-stands. On account of continuous extraction of minerals or oils, these assets go on declining in their value and finally they gets completely exhausted.

4. Obsolescence: There may not be any physical deterioration in the asset itself. Despite of this there may be reduction in the utility of an asset that results from the development of a better method, machine or process. For example, an old machine which is still in good working condition may have to be replaced by a new machine because of the later being more economical as well as efficient. In fact, new inventions, developments in production processes, changes in demand for product or services, etc. make the asset out of date.

5. Accidents: An asset may get reduction in its value if it meets an accident.

6. Permanent fall in the Market Value: Certain assets may get permanent fall in their value and this decline in their value is treated as depreciation. For example, a permanent decline in the market value of securities and investment may be assumed as depreciation

NEED FOR PROVIDING DEPRECIATION

The need for providing depreciation arises on account of the following points:

1. To Ascertain the Profits or Losses: The true profits or losses could be ascertained when all costs of earning revenues have been properly charged against them. Fixed assets like building, plant and machinery, furniture, motor vehicles etc are important tool in earning business income. But the cost of the fixed asset is not charged to profit and loss of the accounting period in which the asset is purchased. Therefore, the cost of the fixed asset less its salvage value must be allocated rationally to the periods that receive benefit from the use of the asset. Thus, depreciation is an item of business expense and must be provided for a proper matching of costs with the revenue.

2. To show the Asset at its Reasonable Value: The assets decrease in their value over a period of time on account of various reasons such as passage of time, constant use, accidents, etc. Therefore, if the depreciation is not charged then the asset will appear in the balance sheet at the over stated value. This practice is unfair as the balance sheet would fail to present the true financial position.

3. Replacement of assets: Business assets become useless at the expiry of their life and, therefore, need replacement. The cash resources of the concern are saved from being distributed by way of dividend by providing for depreciation. The resources so saved, if set aside in each year, may be adequate to replace it at the end of life of the asset.

4. To Reduce Income Tax: If tax is paid on the business income without providing for depreciation then it will be in excess to the actual income tax. This is a loss to the business. Thus, for calculating tax, depreciation should be deducted from income similar to the other expenses as depreciation is a chargeable expense and results in tax benefit.

FACTORS AFFECTING DEPRECIATION

In order to assess depreciation amount to be charged in respect of an asset in an accounting period the following three important factors should be considered:

1. Cost of the asset: The knowledge about the cost of the asset is very essential for determining the amount of depreciation to be charged to the profit and loss account. The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to make the asset usable. Cost of transportation and transit insurance are included in acquisition cost. However, the financial charges such as interest on money borrowed for the purchase for the purchase of the asset should no be included in the cost of the asset.

2. Estimated life of the asset: Estimated life generally means that for how many years an asset could be used in business with ordinary repairs for generating revenues. For estimating useful life of an asset one must begin with the consideration of its physical life and the modifications, if any, made, factors

of obsolescence and experience with similar assets. In fact, the economic life of an asset is shorter than its physical life. The physical life is based mostly on internal policies such as intensity of use, repairs, maintenance and replacements. The economic life, on the other hand, is based mostly on external factors such as obsolescence from technological changes.

3. Scrap Value of the Asset: The salvage value of the asset is that value which is estimated to be realized on account of the sale of the asset at the end of its useful life. This value should be calculated after deducting the disposal costs from the sale value of the asset. If the scrap value is considered as insignificant, it is normally regarded as nil.

METHODS OF CALCULATING DEPRECIATION

There are different concepts about the nature of depreciation. Moreover, the nature of all fixed assets cannot be the same. As a result, different methods are found to exist for charging depreciation. A broad classification of the methods may be summarized as follows:

Methods of Charging Depreciation

Capital / Source Fund	Time Base	Use Base	Price Base
Sinking Fund Method	Fixed Installment Method	Working Hours Method	Revaluation Method
Annuity Method	Reducing Balance Method	Mileage Method	Repairs Provision Method
Insurance Policy Method	Sum Years' Digit Method	Depletion Service Hours Method	-
-	Double Declining Method	Unit Method	-

Straight Line Method

This is also known as fixed installment method. Under this method the depreciation is charged on the uniform basis year after year. When the amount of depreciation charged yearly under this method is plotted on a graph paper, we shall get a straight line. Thus, the straight-line method assumes that depreciation is a function, of time rather than use in the sense that each accounting period received the same benefit from using the asset as every other period. The formula for calculating depreciation charge for each accounting period is:

$$\text{Amount of annual Depreciation} = \frac{\text{Original cost of the fixed assets} - \text{Residual value}}{\text{Estimated Life in years}}$$

For example, if an asset cost Rs. 50,000 and it will have a residual value of Rs. 2000 at the end of its useful life of 10 years, the amount of annual depreciation will be Rs. 4800 and it will be calculated as follow:

$$\text{Depreciation} = \frac{\text{Rs. } 50{,}000 - 2000}{10 \text{ Years}} = \text{Rs. } 4800$$

This method has many shortcomings. First, it does not take into consideration the seasonal fluctuations, booms and depression. The amount of depreciation is the same in that year in which the machine is used day and night and in the another year in which it is used for some months. Second, it ignores the interest on the money spent on the acquisition of that asset. Third, the total charge for use of asset (i.e., depreciation and repairs) goes on increasing from year to year though the assets might have been in use uniformly from year to year. For example, repairs cost together with depreciation charged in the beginning years is much less than what it is in the later years. Thus, each subsequent year is burdened with greater charge for the use of asset on account of increasing cost on repairs.

Illustration 1.

Calculate the Rate of Depreciation under Straight Line Method (SLM) in each of the following:-

Machine No.	Cost of Machine (₹)	Expenses incurred at the time of purchase to be capitalized (₹)	Estimated Residual Value (₹)	Expected Useful Life in years
1	90,000	10,000	20,000	8
2	24,000	7,000	3,100	6
3	1,05,000	20,000	12,500	3
4	2,50,000	30,000	56,000	5

Solution:

Machine No	Cost of Machine (₹)	Expenses incurred at the time of purchase to be capitalized (₹)	Total Cost of Asset = (b+c) (₹)	Estimated Residual Value (₹)	Expected Useful Life in years	Depreciation = (d-e)/f (₹)	Rate of Depreciation under SLM = (g/d)×100
a	b	c	d	e	f	g	h
1	90,000	10,000	1,00,000	20,000	8	10,000	10%
2	24,000	7,000	31,000	3,100	6	4,650	15%
3	1,05,000	20,000	1,25,000	12,500	5	22,500	18%
4	2,50,000	30,000	2,80,000	56,000	10	22,400	8%

Illustration 2.

A machine is purchased for ₹ 7,00,000. Expenses incurred on its cartage and installation ₹ 3,00,000. Calculate the amount of depreciation @ 20% p.a. according to Straight Line Method for the first year ending on 31st March, 2013, if this machine is purchased on:

(a) 1st April, 2012

(b) 1st July, 2012

(c) 1st October, 2012

(d) 1st January, 2013

Solution:

Here, Total Cost of Asset = Purchased Price + Cost of Cartage and Installation

= ₹ 7,00,000 + ₹ 3,00,000 = ₹ 10,00,000

Amount of Depreciation :

$$= \text{Total Cost of Asset} \times \text{Rate of Depreciation} \times \frac{\text{Period from the date of purchase to date of closing accounts}}{12}$$

(a) The machine was purchased on 1st April, 2012:

Amount of Depreciation = ₹ 10,00,000 × 20% × $\frac{12}{12}$ = ₹ 2,00,000

(b) 1st July, 2012

Amount of Depreciation = ₹ 10,00,000 × 20% × $\frac{9}{12}$ = ₹ 1,50,000

(c) 1st October, 2012

Amount of Depreciation = ₹ 10,00,000 × 20% × $\frac{6}{12}$ = ₹ 1,00,000

(d) 1st January, 2013

Amount of Depreciation = ₹ 10,00,000 × 20% × $\frac{3}{12}$ = ₹ 50,000

Diminishing Balance Method

This is also known as Written down value method [WDV]. Under the diminishing balance method depreciation is charged at fixed rate on the reducing balance (i.e., cost less depreciation) every year. Thus, the amount of depreciation goes on decreasing every year. Under this method also the amount of depreciation is transferred to profit and loss account in each of the year and in the balance sheet the asset is shown at book value after reducing depreciation from it. For example, if an asset is purchased for Rs. 10,000 and depreciation is to be charged at 20% p.a. on reducing balance system then the depreciation for the first year will be Rs. 2000. In the second year, it will Rs. 1600 (i.e. 20% of 8000), in the third year Rs. 1280 (i.e. 20% of 6400) and so on.

Merits of Diminishing Balance Method:

(i) It is very easy to understand and calculate the amount of depreciation despite the early variation in the book value after depreciation

(ii) This method puts an equal burden for use of the asset on each subsequent year since the amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year.

(iii) This method has also been approved by the income tax act applicable in India.

Illustration 3.

On 1.1.2011 a machine was purchased for ₹ 1,00,000 and ₹ 50,000 was paid for installation. Assuming that the rate of depreciation was 10% on Reducing Balance Method, calculate amount of depreciation upto 31.12.2013.

Solution:

Year	Opening Book Value (₹)	Rate	Depreciation (₹)	Closing Book Value (₹)
2011	1,50,000	10%	15,000	1,35,000
2012	1,35,000	10%	13,500	1,21,500
2013	1,21,500	10%	12,150	1,09,350

Note: Cost of the machine (i.e. Opening Book Value for the year 2011)

= Cost of Purchase + Cost of Installation

= ₹ 1,00,000 + ₹ 50,000 = ₹ 1,50,000

Illustration 4.

On 1.1.2011 machinery was purchased for ₹ 80,000. On 1.7.2012 additions were made to the amount of ₹ 40,000. On 31.3.2013, machinery purchased on 1.7.2012, costing ₹ 12,000 was sold for ₹ 11,000 and on 30.06.2013 machinery purchased on 1.1.2011 costing ₹ 32,000 was sold for ₹ 26,700. On 1.10.2013, additions were made to the amount of ₹ 20,000. Depreciation was provided at 10% p.a. on the Diminishing Balance Method.

Show the Machinery Accounts for three years from 2011-2013. (year ended 31st December)

Solution:

Statement of Depreciation

Particulars	Machines – I Cost = ₹ 80,000		Machines – II Cost = ₹ 40,000		Machines – III Cost = ₹ 20,000	Total Depreciation
	₹	₹	₹	₹	₹	₹
1.1.2011 Book Value	48,000	32,000				
31.12.2011 Depreciation	4,800	3,200				8,000
01.01.2012 W.D.V.	43,200	28,800				
01.07.2012			28,000	12,000		
31.12.2012 Depreciation	4,320	2,880	1,400	600		9,200
01.01.2013 W.D.V.	38,880	25,920	26,600	11,400		
31.03.2013 Depreciation				285		
W.D.V.				11,115		
Sold For				11,000		
Loss on sale				115		
30.06.2013 Depreciation		1,296				
W.D.V.		24,624				
Sold for		26,700				
Profit on Sale		2,076				
01.10.2013 Purchase					20,000	
31.12.2013 Depreciation	3,888		2,660		500	8,629
01.01.2014 W.D.V.	34,992		23,940		19,500	

Dr. **Machinery Account** **Cr.**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
01.01.11	To, Bank A/c	80,000	31.12.11	By, Depreciation A/c	8,000
				,, Balance c/d	72,000
		80,000			80,000
01.01.12	To, Balance b/d	72,000	31.12.12	By, Depreciation A/c	9,200
01.07.12	,, Bank A/c	40,000		,, Balance c/d	1,02,800
		1,12,000			1,12,000
01.01.13	To, Balance b/d	1,02,800	31.3.13	By, Bank (Sale) A/c	11,000
30.06.13	,, P & L A/c (Profit on Sale)	2,076		,, Depreciation A/c	285
	,, Bank A/c	20,000	30.6.13	,, P & L A/c (Loss on Sale)	115
				,, Bank A/c (Sale)	26,700
			31.12.13	,, Depreciation A/c	1,296
				,, Depreciation A/c	7,048
				,, Balance c/d	78,432
		1,24,876			1,24,876

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.

Provision

Provision means setting aside a part of the profits for meeting a liability in future, the amount of which is not known accurately at the time of finalization of financial statements. In any business, there may be some expected or unexpected eventualities, which must be met by the businessmen without delaying them, further. So based on the convention of conservatism, it is necessary for every business enterprise to conduct the business prudently. For this purpose, necessary provisions and reserves are to be created at the time of preparation of financial statements.

Provision is to be made in respect of a liability, which is certain to be incurred, but its exact amount is not known. If the exact amount can be known, it becomes a liability and not provision. 'Provision for Legal Damages', 'Provision for Depreciation', 'Provision for Taxation', 'Provision for Doubtful Debts', and 'Provision for Discount on Debtors' are few examples of provisions.

Provision is a charge against the profits, which means that irrespective of the fact whether business enterprise is earning sufficient profit or not, provision has to be made in the financial statements. Even in the case when the business enterprise is suffering heavy losses, provisions are to be made. It is worth mentioning that creation of provision does not affect flow of cash because it is an internal transaction.

According to Part III, Schedule VI of the Companies Act, 1956, 'provision' means "any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

Objectives of Provisions:

1. For Ascertainment of True Net Profit:

For ascertaining true net profit of the business, expenses pertaining to that year, paid or outstanding must be shown in Profit and Loss Account. In addition a

provision should also be created for those expenses or liabilities for which the exact amount is unknown or cannot be ascertained accurately. For example provision created for doubtful debts, provision for discount on debtors etc.

2. For Ascertainment of True Financial Position:

The business must make adequate provisions for all expenses and losses, only then the Balance sheet will depict the true and fair view of the financial position of business.

3. To Provide for Known Losses in the Future:

For meeting a liability in future, the amount for which is unknown, steps should be taken to set, aside a part of profits. For example, provision for taxation, provision for repairs, provision for bad debts etc.

4. For Uniform Charge on Income Statements:

For equal distribution of expenses and losses in all the years so that proper analysis can be made, provisions are required to be created. For example, Rs. 10,000 was to be incurred during the entire life of the machine, estimated life of which was 10 years.

In this case, instead of debiting Rs. 10,000 in a single year, it should be divided and debited in 10 years in such a way that Profit and Loss Account shall be burdened according to the benefits derived from usage of the machine during 10 years.

Types and treatment of Provision in accounting:

Thus the creation of provision ensures proper matching of revenues and expenses and calculation of true profit. The following provisions are created at the time of preparing financial statement:

1. Provision for Bad and Doubtful Debts:

Generally, there are some of the debts, which cannot be realized from the debtors/receivable due to various reasons like death of debtors; insolvency, liquidation or debtors are not traceable etc. These types of debtors/receivable are treated in the books as a term of bad debts.

2. Provision for Discount to debtors:

To get payment earlier we have to give the discount to our sundry debtors/ Receivables. So, a provision for discount to debtors/receivable in the current year is to be made.

3. Provision for Discount from Creditors:

The creditors/payable will also give us a discount to get paid earlier. So, a provision for the discount from Creditors/Payable in the current year is to be made. However, in practicality if, there is an agreement between the business and the creditors for some provision of discount/cash back (as in case of digital transactions nowadays), only then, shall one provide for the discount from creditors. The discount provision is available in advance as a rate or as mentioned in the agreement.

4. Provision for Taxation:

The Provision for taxation is created to meet expected income tax payable on the income of the current year.

5. Provision for Depreciation:

The depreciation charged till date appears in the provision for depreciation account, which is shown either on the “liabilities side” of the balance sheet or by way of deduction from the original cost of the asset concerned on the asset side of the balance sheet.

Reserve

Reserve means an appropriation of profits or other surpluses to strengthen the liquid resources of the business enterprise and not for meeting any liability, contingency or any commitment of the business.

According to William Pickles, "Reserve means the amount set aside out of profit and other surpluses, which are not earmarked in any way to meet any particular liability known to exist on the date of Balance Sheet."

Actually, in addition to the capital contributed by the proprietor, the amount set aside from the profits or surpluses to reserves belongs to the proprietor, which will help the business during difficult financial period. It is an appropriation of profits and not charged on the profits. This means that in the case of loss, reserves cannot be created. Reserves help in strengthening the financial position of the business enterprise.

They are not created to meet any liabilities, contingencies or commitments. It is important to mention here that the business cannot create reserves in anticipation of some losses; however, in case of loss, reserves can be utilized. When amount of reserve is invested in some outside securities it is known as 'Reserve Fund'. Since reserves are appropriation and not charge against profits, they are shown in Profit and Loss Appropriation Account instead of Profit and Loss Account.

Importance of Reserves:

(i) Strengthening the Financial Position:

Reserves help in strengthening the financial position of the enterprise, since it can be used to meet any unforeseen losses that may arise in future.

(ii) Source of Internal Financing:

By creating the reserves, profits are ploughed back into the business, which can be used as source of finance.

(iii) Enhancing the Reputation of Enterprise:

In order to enhance the reputation or image of the company, regular dividends must be paid to the shareholders in time. It is also necessary that the dividend should be equalized over the years. This objective can be achieved, if the company maintains reserves because in the years of inadequacy of profits, amount can be withdrawn from these reserves and paid to the shareholders.

(iv) Keeping Working Capital Intact:

Reserve increases the working capital of the business enterprise. So in emergent and unforeseen circumstances, business enterprise can use the amount kept in reserves and keep working capital to the required level.

(v) Facilitating Heavy Amount when Needed:

Reserves can be created for some specific purpose, which can be used to meet that purpose only. For the redemption of debentures, company has to pay huge amount to debenture holders. When the debentures become due for payment, the company may face a financial difficulty, because a large amount is generally required for redemption of debentures.

If, in a single go, such a large sum is to be paid out of the working capital, the operational efficiency of the company may get affected adversely. Hence, it is always a prudent policy for a company to retain some money out of its profits for redeeming the debentures.

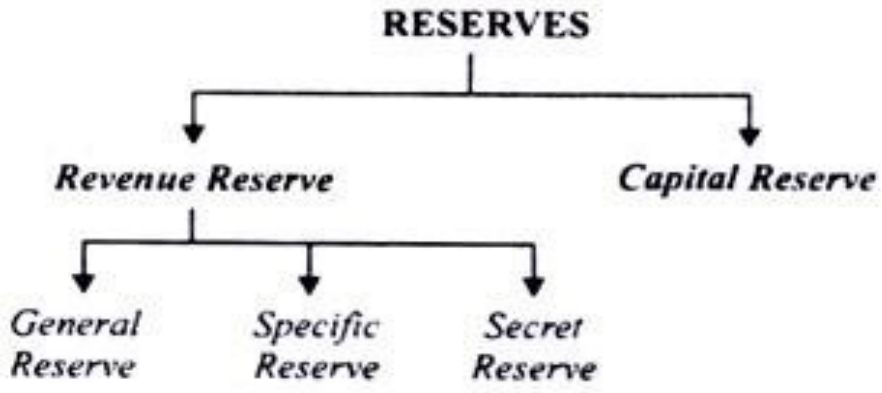
For this purpose 'Debenture Redemption Reserve' can be maintained by the company, in which a fixed amount of profit is transferred. This will facilitate payment of such huge sum, when repayment to debenture holders is due.

Types of Reserves:

Broadly, there are two types of reserves:

(i) Revenue reserves and

(ii) Capital Reserves



1. Revenue Reserves:

Revenue reserves are created out of profits, which have been earned in the normal course and from the day to day activities of the business concern.

Revenue reserves may further be classified as:

(i) General Reserve

(ii) Specific Reserve and

(iii) Secret Reserve.

(A) General Reserve:

General reserve is that amount of profits, which are set aside to meet some future contingencies and not created for any specific purpose. These are generally retained for strengthening the financial position of the business concern and to provide additional working capital for the business when needed. Since this reserve can be utilised to meet any unknown purpose, so it is also called 'Contingency Reserve' or 'Free Reserve'.

In any business enterprise, general reserve is created for the following purposes:

(a) To strengthen the financial position of the business concern

(b) To make available additional working capital all the times

(c) To meet any liability or contingency, in case of unforeseen circumstances

(d) To equalize the rate of dividend over the years in case of inadequate profits

(B) Specific Reserve:

Specific reserves are created for some specific purposes. These reserves cannot be utilised for any purpose other than the purpose for which they were created. However, if the article of association permits then at the discretion of board of directors, specific reserves may be used for a purpose other than the purpose of its creation.

Some examples of specific reserves are as under:

1. Dividend Equalization Reserve

2. Debenture Redemption Reserve

3. Investment Fluctuation Reserve

4. Workmen Compensation Fund

(i) Dividend Equalization Reserve:

Dividend equalization reserve is created to equalize the rate of dividend over the years. Usually, in the year of large and adequate profits, a portion of profits is transferred in this account and in the year of inadequate profits, the amount kept in this account can be used for paying the dividend to the shareholders.

This reserve is created by way of the following journal entry:

Profit and Loss Appropriation A/c Dr.

To Dividend Equalization Reserve A/c

(ii) Debenture Redemption Reserve:

Debenture redemption reserve is created for the purpose of redemption of debentures at the end of some specific period. In this connection, every year a specific sum out of the divisible profits is set-aside in this reserve. The amount is to be invested in securities. The amount accumulated with compound interest produces the required amount, which has to be paid to debenture holders.

This reserve is created by way of the following journal entry:

Profit and Loss Appropriation A/c Dr.

To Debenture Redemption Reserve A/c

(iii) Investment Fluctuation Reserve:

Sometimes business enterprises invest their surplus funds outside their business in shares, debentures or other securities. Also, the price of such investments keeps on changing, depending on certain market conditions and/or government policies etc. To bear any loss in case of decrease in value of such investments, business enterprises sets aside a part of profit in Investment Fluctuation Reserve, so that any loss arising on account of decrease in value of such investment can be met from this reserve.

This reserve is created by way of the following journal entry:

Profit and Loss Appropriation A/c Dr.

To Investment Fluctuation Reserve A/c

(iv) Workmen Compensation Fund:

Workmen Compensation Fund is created to meet the claims of the workers in case they get injured from an accident.

This can be created by way of the following journal entry:

Profit and Loss Appropriation A/c Dr.

To Workmen Compensation find A/c

(C) Secret Reserve:

Secret reserve is a reserve that does not appear in the balance sheet. It can be created in the years of higher profits and can be merged with the profits during the lean periods. Secret reserves can be created as under:

(i) By undervaluing stock,

(ii) By making excessive provisions then the required,

(iii) By charging capital expenditure to revenue,

(iv) By showing contingent liabilities as actual liabilities of the enterprise.

Secret reserve is secret in the sense that the outsiders do not know it. It is suggested that keeping in view the requirement of the case, secret reserve should be created within reasonable limits.

2. Capital Reserves:

Capital reserves are the reserves created out of capital profits.

Following are the examples of some items, which may form capital reserves:

1. Profit on Sale of Fixed Assets

2. Profit on Revaluation of Fixed Assets

3. Securities Premium received on Issue of Shares or Debentures.

4. Profit on Redemption of Debentures.

5. Profit prior to Incorporation

6. Profit on Reissue of Forfeited Shares, etc.

Capital reserves can be utilized for writing off capital losses. However, in the case of joint stock Company, capital reserves can also be utilized for issuing fully paid bonus shares to the members. Generally, capital reserves are not available to shareholders for distribution of profits.

However, some capital reserves such as profit on sale of fixed assets can be utilized for distribution as dividend, if the following conditions are satisfied:

(i) Articles of Association permit the company to do so,

(ii) The profits on sale of fixed asset must have been realized by the company in cash,

(iii) Such profits exist after revaluation of all assets and liabilities and not due to revaluation of assets only.

Basis of Difference	Reserves	Provisions
1. Meaning	It is created to meet an unknown liability.	It is created to meet a known liability.
2. Necessity	Creation of reserves is discretionary. It can be created only if adequate profits have been earned.	Creation of provision is a legal necessity. Provisions have to be provided for even if there are no profits.
3. Object	The object of reserves is to strengthen the financial position of the business.	The object of provisions is to provide for depreciation, doubtful debts and other specific liabilities.
4. Mode of Creation	It is created through P& L Appropriation A/c. As such it is created after the calculation of net profit.	It is created by debiting to P&L A/c. Hence, net profit cannot be calculated unless all provisions have been debited to P & L A/c.
5. Investment outside the business	Reserves may be invested outside the business.	Provisions are never invested outside the business.
6. Appearance in Balance Sheet	It is shown in the liabilities side under the head 'Reserves and Surplus.	It is either shown on the assets side by way of deduction from the asset for which it is created or as a distinct item on the liabilities side.

CONCEPT OF INCOME

One of the most significant accounting concepts is “Concept of Income”. Similarly, measurement of a business income is also an important function of an accountant. In General term, payment received in lieu of services or goods are called income, for example, salary received by any employee is his income. There may be different type of incomes like Gross income, Net income, National Income, and Personal income, but we are here more concerned for a business income. Surplus revenue over expenses incurred is called as “Business Income.”

Objectives of Net Income

Following are the important objectives of a net income:

- Historical income figure is the base for future projections.
- Ascertainment of a net income is necessary to give portion of profit to employees.
- It helps to evaluate the activities, which give higher return on scarce resources. It helps to increase the wealth of a firm.
- Ascertainment of a net income is helpful for paying dividends to the shareholders of any company.
- Return of income on capital employed, gives an idea of overall efficiency of a business.

Definition of Income

The American Accounting Association gives the most authentic definition of income, which is as follows:

“The realized net income of an enterprise measures its effectiveness as an operative unit and is the change in its net assets arising out of a (a) the excess or deficiency of revenue compared with related expired cost, and (b) other gains or losses to the enterprise from sales, exchange or other conversion of assets.”

According to the American Accounting Association, to be as business income, income should be realized. For example, to be a business income, only appreciation in value of assets of a company is not enough, for this, asset has really been disposed of.

For the measurement of any income concerns, instead of a point of time, a span of time is required. Creditors, investors, owners, and government, all of them require systematic accounting reports at regular and proper intervals. The maximum interval between reports is one year, as it helps a businessman to take any corrective action.

An accounting period concept is directly related to matching concept and realization concept; in the absence of any of them, we could not measure income of the concerns. On the basis of matching concept, expenses should be determined in a particular accounting period (usually a year) and matched with the revenue (based on realization concept) and the result will be income or loss of the accounting period.

Accounting Concept and Income Measurement

The measurement of accounting income is the subject to several accounting concepts and conventions. Impact of accounting concepts and convention on measurement of the accounting income is given below –

- **Conservatism**

Where an income of one period may be shifted to another period for the measurement of income is called as 'conservatism approach.'

According to the convention of conservatism, the policy of playing safe is followed while determining a business income and an accountant seeks to ensure that the reported profit is not over stated. Measurement of a stock at cost or market price, whichever is less is one of the important examples as applied to measurement of income. But it must be insured that providing excessive depreciation or excessive provisions for a doubt full debt or excessive reserve should not be there.

- **Consistency**

According to this concept, the principle of consistency should be followed in accounting practice for example, in the treatment of assets, liabilities, revenues, and expenses to insure the comparison of accounting results of one period with another period.

Therefore, the accounting profession and the corporate laws of most of the countries require that financial statement must be made out on the basis that the figures stated are consistent with those of the preceding year.

- **Entity Concept**

Proprietor and business are the two separate and different entities according to the entity concept. For example, an interest on capital is business expenditure, but for a proprietor, it is an income. Thus, we cannot treat a business income as personal income or vice-versa.

- **Going Concern Concept**

According to this concept, it is assumed that business will continue for a long time. Thus, charging depreciation on a Fixed Asset is based on this concept.

- **Accrual Concept**

According to this concept, an income must be recognized in the period in which it was realized and costs must be matched with the revenue of that period.

- **Accounting Period**

It is desirable to adopt a calendar year or natural business year to know the results of business.

Computation of Business Income

To compute business income, following are the two methods –

1. **Balance Sheet Approach**

Comparison of the closing values (Assets minus outsider's liabilities) of a firm with the values at the beginning of that accounting period is called as Balance Sheet

approach. In above value, an addition to capital will be subtracted and addition of drawings will be added while computing the business income of a firm. Since, income is calculated with the help of Balance Sheet hence called as Balance Sheet approach.

2. **Transaction Approach**

Transactions are mostly related to production or the purchase of goods and the sale of goods and all these transactions directly or indirectly related to the revenue or to the cost. Therefore, surplus collection of the revenue by selling goods, spent over for production or purchasing the goods is the measure of income. This system is widely followed by the enterprises where double entry system adopted.

Measurement of Business Income

There are following two factors which are helpful in the estimation of an income −

- **Revenues** − Sale of goods and rendering of services are the way to generate revenue. Therefore, it can be defined as consideration, recovered by the business for rendering services and goods to its customers.

- **Expenses** − An expense is an expired cost. We can say the cost that have been consumed in a process of producing revenue are the expired cost. Expenses tell us - how assets are decreased as a result of the services performed by a business.

Measurement of Revenue

Measurement of the revenue is based on an accrual concept. Accounting period, in which revenue earned, is the period of revenue accrues. Therefore, a receipt of cash and revenue earned are the two different things. We can say that revenue is earned only when it is actually realized and not necessarily, when it is received.

Measurement of Expenses

- In case of delivery of goods to its customers is a direct identification with the revenue.

- Rent and office salaries are an indirect association with the revenue.

There are four types of events (given below) that need proper consideration about as an expense of a given period and expenditure and cash payment made in connection with those items –

- Expenditure, which are expenses of the current year.
- Some expenditure, which are made prior to this period and has become expense of the current year.
- Expenditure, which is made this year, becomes expense in the next accounting periods. For example, purchase of fixed assets and depreciation in next up-coming years.
- Expense of this year, which will be paid in next accounting years. For example, outstanding expenses.

For concept of depreciation:

1: https://www.youtube.com/watch?v=Q3h0gwH3WDs

2: https://www.youtube.com/watch?v=EhIjZZmY9jY

For straight line method

https://www.youtube.com/watch?v=izk6NVuGurU&list=PLGRG6Dk7lyZ7lvMLVH4Q0EHUhFlP2Jmz7&index=3

For written down value method

https://www.youtube.com/watch?v=agCV8rFr17o&list=PLGRG6Dk7lyZ7lvMLVH4Q0EHUhFlP2Jmz7&index=4

For problems

https://www.youtube.com/watch?v=EziM9lCVfp0&list=PLGRG6Dk7lyZ7lvMLVH4Q0EHUhFlP2Jmz7&index=5

https://www.youtube.com/watch?v=BoeiE8WRUto&list=PLGRG6Dk7lyZ7lvMLVH4Q0EHUhFlP2Jmz7&index=6

https://www.youtube.com/watch?v=PKga6zI10LQ&list=PLGRG6Dk7lyZ7lvMLVH4Q0EHUhFlP2Jmz7&index=7