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CUET · ACCOUNTANCY · CLASS XI · CODE 301

# Depreciation, Provisions and Reserves

CUET unit: Depreciation, Provisions and Reserves

By **UniDrill** · NCERT-grounded study material

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# 📌 Snapshot

- Operationalises the **matching principle** for long-lived assets: the cost of a fixed asset must be spread as **depreciation** over the periods that benefit from it (NCERT §7.1, p. 226-227).
- Establishes the two NCERT-mandated methods — **Straight Line Method (SLM)** and **Written Down Value (WDV) Method** — and the two ways of recording depreciation (charge to asset account vs Provision for Depreciation account) (NCERT §7.6, §7.8, p. 234-241).
- Develops **Asset Disposal Account** mechanics, computation of profit/loss on sale, and treatment of insurance claims on destroyed assets (NCERT §7.9.1, p. 251-252).
- Section II distinguishes a **Provision** (charge against profit; known liability of uncertain amount) from a **Reserve** (appropriation of profit), classifies reserves into general / specific and revenue / capital, and explains **Secret Reserves** as a special case (NCERT §7.11-§7.13, p. 262-268).
- High-yield CUET zone: definitional traps (depreciation vs depletion vs amortisation), numerical computation of SLM / WDV depreciation, the WDV rate formula, and provision-vs-reserve distinctions.
- The same toolkit carries into the preparation of financial statements in Class XI Part II (keac2).

# 📖 Detailed Notes

## 2.1 Core concepts

**Depreciation** is a permanent, continuing and gradual shrinkage in the book value of a fixed asset, based on the cost of the asset (NCERT §7.1.1, p. 227). Depreciation is based on **cost** — not market value — consistent with the historical-cost concept (keac102). The **Accounting Standard AS-6 (Revised)** definition: depreciation is "a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from **use, effluxion of time or obsolescence** through technology and market-change", and includes amortisation of assets whose useful life is pre-determined (NCERT Box 1, p. 228). Five **features** are listed in §7.1.2 (p. 229): (i) decline in book value of fixed assets, (ii) caused by effluxion of time, usage or obsolescence, (iii) a

continuing process, (iv) an expired cost deductible before taxable profits, and (v) a **non-cash expense** with no cash outflow.

Depreciation differs from two cognate concepts. **Depletion (§7.2.1, p. 230)** applies to the extraction of natural resources — mines, quarries — and refers to the exhaustion of economic resources. **Amortisation (§7.2.2, p. 230)** applies to the writing off of intangible assets such as patents, copyrights, trademarks, franchises and goodwill. CUET often swaps these three terms.

The **causes of depreciation (§7.3, p. 230-231)** are four: (a) **wear and tear** due to use or passage of time; (b) **expiration of legal rights** in the case of patents, copyrights and leases; (c) **obsolescence** caused by technological changes, improved methods of production or demand shifts; and (d) **abnormal factors** such as accidents, fire, earthquake and floods. The **need for depreciation (§7.4, p. 231-232)** is also four-fold: (i) matching of costs and revenue, (ii) providing a tax-deductible expense, (iii) showing a true and fair financial position (else assets are overvalued), and (iv) compliance with legal provisions of the Companies Act and the Income Tax Act.

Three parameters determine the amount of depreciation (NCERT §7.5, p. 232): **Cost of asset, Estimated useful life, Probable salvage (net residual) value.** Each is then unpacked. **Cost (§7.5.1, p. 232-233)** = invoice price + freight + transit insurance + installation + registration + commission + initial repairs on second-hand assets — i.e., the total cost of acquisition, installation and commissioning. **Net residual / scrap / salvage value (§7.5.2, p. 233)** = estimated net realisable value at the end of useful life minus disposal expenses. **Depreciable cost (§7.5.3, p. 233)** = Cost – Net residual value; this is the amount that is spread over the asset's useful life. **Useful life (§7.5.4, p. 233-234)** is the estimated economic / commercial life — not the physical life — and can be expressed in years, units of output or working hours.

There are two methods of depreciation. The **Straight Line Method (SLM) (§7.6.1, p. 234-235)** charges a fixed equal amount each year. The formula is **Depreciation = (Cost − Estimated net residual value) ÷ Estimated useful life**. The book value can be reduced to zero (or scrap value) at the end of the useful life. SLM is also called the fixed instalment method or the fixed percentage on original cost method. The **Written Down Value (WDV) Method, or Reducing Balance Method (§7.6.2, p. 236-238),** applies a pre-determined percentage to the book value at the beginning of the period — so the depreciation amount declines year after year. The rate is computed as $\mathbf{R = [1 - \sqrt[n]{(s/c)}] \times 100}$, where n is the useful life in years, s is the scrap value and c is the cost. NCERT works through a numerical example: cost ₹9,00,000, residual ₹50,000, useful life 16 years → R = (1 – 0.834) × 100 = 16.6%.

The **comparison of SLM and WDV (§7.7 and Fig. 7.3, p. 238-240)** is the single most heavily tested CUET topic of this chapter. SLM charges on original cost with a fixed annual amount; WDV charges on book value with a declining amount. SLM brings the book value down to zero / scrap; WDV never brings it to zero. SLM is **not recognised by Income Tax Law**; **WDV is recognised** (the most-inverted fact in CUET

MCQs). SLM suits assets with low repairs and obsolescence — land, buildings, patents; WDV suits assets needing high repair or affected by technology — plant, vehicles. Limitation of WDV: depreciable cost can never be fully written off (NCERT §7.6.2.2, p. 238).

Two **methods of recording depreciation (§7.8, p. 240-241)** are discussed: (a) **Charging depreciation to the asset account** — the asset appears at its net book value on the balance sheet; (b) **Creating a Provision for Depreciation (Accumulated Depreciation) account** — the asset stays at its original cost in the books, while a parallel Provision account accumulates the periodic depreciation charges and is deducted from the asset on the balance sheet. Method (b) is the more informative because it preserves original cost as a reference.

**Disposal of asset (§7.9, p. 251-252).** When a depreciated asset is sold, the firm consolidates all sale-related entries in an **Asset Disposal Account**: the original cost is transferred to it (from the asset account); the accumulated depreciation up to the date of sale is credited; the sale proceeds are credited; the balance is the **profit or loss on sale**, transferred to P&L. If the asset is destroyed by fire, the insurance claim is credited to the Disposal A/c and any shortfall is the loss on destruction (NCERT Illustration 9, p. 257-259).

**Effect of additions or extensions (§7.10, p. 259).** AS-6 prescribes that if the addition becomes an integral part of the existing asset, it is depreciated over the useful life of that asset; if it has a separate identity, it is depreciated on its own useful life.

**Provisions and reserves** form the second half of the topic. A **Provision (§7.11, p. 262)** is an amount set aside for known liabilities or losses pertaining to the current accounting period whose amount cannot be measured with substantial accuracy — examples include Provision for Depreciation, Provision for Doubtful Debts, Provision for Discount on Debtors, Provision for Taxation, and Provision for Repairs and Renewals. Provisions are created by debiting the P&L Account — they are charges against profit.

A **Reserve (§7.12, p. 264)** is an appropriation of profit (not a charge) created to strengthen the financial position of the firm or to meet specific future needs. Reserves are shown under "Reserves and Surpluses" on the liabilities side of the balance sheet, after Capital. The **Reserve vs Provision distinction (§7.12.1 and Fig. 7.4, p. 264-266)** is tested almost every CUET year: a provision is a charge against profit (it reduces net profit before tax), a reserve is an appropriation of profit (created from already-computed net profit); a provision is mandatory even at a loss, a reserve presupposes the existence of profits; a provision cannot be used for dividend distribution, whereas a **general reserve** can be used for dividend.

Reserves are then classified into **General Reserves** — created without a specific purpose, also called "free reserves" — and **Specific Reserves** such as the Dividend Equalisation Reserve, the Workmen's Compensation Fund, the Investment Fluctuation Fund and the Debenture Redemption Reserve (NCERT §7.12.2, p. 266). They are also classified as **Revenue Reserves** — created out of operating profits and freely available

for dividend distribution — and **Capital Reserves**, created out of capital profits and not available for dividend (usable only for writing off capital losses or issuing bonus shares). Capital profits include premium on issue of shares / debentures, profit on sale of fixed assets, profit on redemption of debentures, profit on revaluation, profits prior to incorporation, and profit on reissue of forfeited shares (NCERT §7.12.2(a)–(b), p. 266-267).

A special case is **Secret Reserves (§7.13, p. 268)**: reserves not disclosed on the balance sheet, created by charging excessive depreciation, undervaluing inventory, charging capital expenditure to P&L, making excessive provisions for doubtful debts, or showing contingent liabilities as actual liabilities. Secret reserves reduce apparent profits (and taxes), but they distort the true-and-fair view and are therefore prohibited for joint-stock companies under the Companies Act.

## 2.2 Definitions to memorise

| Term | Definition | Page |
|---|---|---|
| Depreciation | Permanent, continuing, gradual shrinkage in book value of fixed assets due to use, effluxion of time or obsolescence (NCERT §7.1.1, AS-6 Box 1). | 227-228 |
| Depletion | Decline in value of natural resources (mines, quarries) due to extraction (NCERT §7.2.1). | 230 |
| Amortisation | Periodic write-off of cost of intangible assets — patents, copyrights, trademarks, goodwill (NCERT §7.2.2). | 230 |
| Cost of asset | Invoice price + freight + transit insurance + installation + registration + initial repairs on second-hand assets (NCERT §7.5.1). | 232-233 |
| Net residual / scrap / salvage value | Estimated net realisable value at end of useful life minus disposal expenses (NCERT §7.5.2). | 233 |
| Depreciable cost | Original cost minus estimated net residual value; the amount spread over useful life (NCERT §7.5.3). | 233 |
| Useful life | Estimated economic / commercial life of an asset (NCERT §7.5.4). | 233-234 |
| Straight Line Method | Fixed equal annual charge; formula = (Cost – Salvage) / Useful life (NCERT §7.6.1). | 234-235 |
| Written Down Value Method | Fixed percentage on opening book value; declining charge; $R = [1 - \sqrt[n]{(s/c)}] \times 100$ (NCERT §7.6.2). | 236-238 |
| Provision for Depreciation A/c | Accumulated Depreciation account; asset stays at original cost; provision deducted on balance sheet (NCERT §7.8). | 240-241 |
| Asset Disposal A/c | | 251-252 |

| Term | Definition | Page |
|---|---|---|
| | Consolidating account on sale of an asset; original cost Dr; accumulated depreciation and sale proceeds Cr; balance = profit/loss (NCERT §7.9.1). | |
| Provision | Charge against profit for a known liability/expense of uncertain amount (NCERT §7.11). | 262 |
| Reserve | Appropriation of profit retained in business to strengthen financial position (NCERT §7.12). | 264 |
| General Reserve | Free reserve with no specific purpose; available for dividend (NCERT §7.12.2). | 266 |
| Specific Reserve | Reserve earmarked for a specific purpose (dividend equalisation, debenture redemption, workmen compensation, etc.) (NCERT §7.12.2). | 266 |
| Revenue Reserve | Reserve created out of operating profits; available for dividend (NCERT §7.12.2(a)). | 266 |
| Capital Reserve | Reserve created out of capital profits; not available for dividend distribution (NCERT §7.12.2(b)). | 267 |
| Secret Reserve | Undisclosed reserve created by under-stating profits or over-stating expenses/provisions (NCERT §7.13). | 268 |
| Capital Profit | Profit not arising from normal operations — premium on issue of shares/debentures, profit on sale of fixed asset, profit on revaluation, profits prior to incorporation, profit on reissue of forfeited shares (NCERT §7.12.2(b)). | 267 |
| Provision for Doubtful Debts | Provision created on debtors expected to be irrecoverable (NCERT §7.11). | 262 |
| Provision for Discount on Debtors | Provision for discount likely to be allowed to debtors paying within stipulated period (NCERT §7.11). | 262 |
| Provision for Taxation | Provision for the firm's tax liability for the period (NCERT §7.11). | 262 |
| Workmen Compensation Fund | Specific reserve for potential workers' compensation claims (NCERT §7.12.2). | 266 |
| Debenture Redemption Reserve | Specific reserve created out of profits to redeem debentures on maturity (NCERT §7.12.2). | 266 |

## 2.3 Diagrams / processes to remember

**Fig. 7.1 — Depreciation under SLM (NCERT p. 235).** A horizontal flat line indicating that the annual depreciation charge is constant over the useful life. The total accumulated depreciation rises linearly.

**Fig. 7.2 — Depreciation under WDV (NCERT p. 237).** A downward-sloping curve indicating that annual depreciation charges decline year after year. Although the curve approaches the x-axis asymptotically, it never touches it.

**Fig. 7.3 — Comparative Table SLM vs WDV (NCERT p. 240).** Five bases: charging basis (original cost vs book value), annual charge (constant vs declining), total of depreciation + repairs (roughly even under WDV because repairs rise as depreciation falls; uneven under SLM), Income Tax recognition (only WDV), suitability (SLM for low-repair / low-obsolescence assets; WDV for high-repair / high-obsolescence assets).

**Fig. 7.4 — Provision vs Reserve (NCERT p. 265-266).** Six bases: nature (charge vs appropriation), purpose (specific liability vs general strengthening), taxable profits (provision reduces; reserve does not), presentation (deducted from concerned asset vs liability side), compulsion (mandatory vs discretionary), dividend use (provision cannot; general reserve can).

**Fig. 7.5 — Revenue Reserve vs Capital Reserve (NCERT p. 267-268).** Three bases: source of profit, purpose, and usage (dividend distribution allowed only for revenue reserve).

**Illustration 1 worked example — SLM (NCERT p. 242).** Machine cost ₹50,000 + installation ₹5,000 = ₹55,000; useful life 10 years; residual ₹5,000. SLM = (55,000 – 5,000) / 10 = ₹5,000 per year.

**Illustration 4 worked example — WDV (NCERT p. 246-247).** Machinery ₹2,10,000 (cost + installation); 10% WDV. Year 1 = ₹21,000; Year 2 = ₹18,900; Year 3 = ₹17,010.

**Illustration 6 — Truck Disposal A/c (NCERT p. 253-255).** Demonstrates calculation of profit/loss on sale when the asset has been depreciated under either method.

**Illustration 9 — Plant destroyed by fire (NCERT p. 257-259).** Plant Disposal A/c with insurance claim — accumulated depreciation transfer and computation of loss on destruction.

**Process — SLM computation.** (i) Compute total cost (invoice + freight + installation + registration). (ii) Subtract estimated salvage value. (iii) Divide by useful life. (iv) Apply the fixed amount every year until book value = salvage value.

**Process — WDV computation.** (i) Compute total cost. (ii) Determine the WDV rate (either given or computed via $R = [1 - \sqrt[n]{(s/c)}] \times 100$). (iii) For year 1, apply rate to cost. (iv) For year 2 and beyond, apply rate to the opening book value of that year. (v) Book value approaches but never reaches zero.

## 2.4 Common confusions / NTA trap points

1. **Depreciation vs Depletion vs Amortisation.** Depreciation = tangible fixed assets; Depletion = natural resources (mines, quarries); Amortisation = intangibles (patents, goodwill, trademarks). NTA loves swapping these (NCERT §7.1-§7.2).

2. **SLM book value reaches zero / scrap; WDV book value never reaches zero.** A classic trap (NCERT §7.6.1 vs §7.6.2.2).
3. **Recognition by Income Tax Law.** Only **WDV** is recognised — SLM is not. Students invert this regularly (NCERT §7.7, p. 239).
4. **Provision is a CHARGE; Reserve is an APPROPRIATION.** Hence net profit is calculated after deducting provisions but before creating reserves (NCERT §7.11-§7.12).
5. **General reserve CAN be used for dividend; provision CANNOT.** Capital reserve also CANNOT be used for dividend (NCERT Fig. 7.4 & §7.12.2).
6. **Secret reserve is created by charging** excessive **depreciation, not less.** Under-statement of profits is the hallmark — students sometimes get the direction wrong (NCERT §7.13, p. 268).
7. **Capital Reserve is NOT available for dividend.** Only for writing off capital losses or issuing bonus shares (NCERT §7.12.2(b), p. 267).
8. **Cost of asset** includes installation, freight, transit insurance, registration — students often exclude installation when computing the depreciation base (NCERT §7.5.1, p. 232-233).
9. **WDV depreciation does NOT remain constant.** It declines each year because it is applied to a shrinking base (NCERT §7.6.2, p. 236).
10. **Depreciation is a non-cash expense.** No cash leaves the firm when depreciation is recorded — students sometimes treat it as a cash outflow (NCERT §7.1.2, p. 229).
11. **Sale proceeds vs accumulated depreciation.** On disposal, profit = sale proceeds – (cost – accumulated depreciation); negative figure = loss. Easy to invert (NCERT Illustration 6, p. 253).
12. **Provision for Doubtful Debts is a provision, not a reserve.** It is a charge against profit even at a loss — many students wrongly classify it as a reserve (NCERT §7.11, p. 262).

## 2.5 Journal entry templates

### (a) Charging depreciation directly to the asset account (NCERT §7.8, p. 240)

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| Mar 31 | Depreciation A/c .....Dr. | | 5,000 | |
| | To Machinery A/c | | | 5,000 |
| | (Being depreciation charged for the year) | | | |

### (b) Creating a Provision for Depreciation (NCERT §7.8, p. 240-241)

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| Mar 31 | Depreciation A/c .....Dr. | | 5,000 | |
| | To Provision for Depreciation A/c | | | 5,000 |
| | (Being depreciation provided; asset continues at original cost) | | | |

### (c) Transferring depreciation to Profit and Loss (NCERT §7.8)

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| Mar 31 | Profit and Loss A/c .....Dr. | | 5,000 | |
| | To Depreciation A/c | | | 5,000 |
| | (Being depreciation charged to P&L) | | | |

### (d) Sale of asset — transfer to Asset Disposal A/c (NCERT §7.9.1, p. 251)

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| Jun 30 | Asset Disposal A/c .....Dr. | | 1,00,000 | |
| | To Machinery A/c | | | 1,00,000 |
| | (Being original cost of machinery sold transferred to Disposal A/c) | | | |
| | Provision for Depreciation A/c .....Dr. | | 60,000 | |
| | To Asset Disposal A/c | | | 60,000 |
| | (Being accumulated depreciation transferred to Disposal A/c) | | | |
| | Bank A/c .....Dr. | | 35,000 | |
| | To Asset Disposal A/c | | | 35,000 |
| | (Being sale proceeds received) | | | |

### (e) Loss on sale transferred to P&L (NCERT Illustration 6, p. 253-255)

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| Jun 30 | Profit and Loss A/c .....Dr. | | 5,000 | |
| | To Asset Disposal A/c | | | 5,000 |

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| | (Being loss on sale: cost 1,00,000 – acc. dep. 60,000 – sale 35,000 = ₹5,000 loss) | | | |

### (f) Asset destroyed by fire; insurance claim received (NCERT Illustration 9, p. 257)

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| Mar 31 | Asset Disposal A/c .....Dr. | | 2,00,000 | |
| | To Plant A/c | | | 2,00,000 |
| | Provision for Depreciation A/c .....Dr. | | 80,000 | |
| | To Asset Disposal A/c | | | 80,000 |
| | Insurance Co. A/c .....Dr. | | 1,00,000 | |
| | To Asset Disposal A/c | | | 1,00,000 |
| | Profit and Loss A/c .....Dr. | | 20,000 | |
| | To Asset Disposal A/c | | | 20,000 |
| | (Being plant destroyed by fire; insurance settled at ₹1,00,000; balance ₹20,000 loss to P&L) | | | |

### (g) Creating Provision for Doubtful Debts (NCERT §7.11, p. 262)

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| Mar 31 | Profit and Loss A/c .....Dr. | | 6,000 | |
| | To Provision for Doubtful Debts A/c | | | 6,000 |
| | (Being 5% provision on debtors of ₹1,20,000 — charge against profit) | | | |

### (h) Transfer to General Reserve (NCERT §7.12.2, p. 266)

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| Mar 31 | Profit and Loss Appropriation A/c .....Dr. | | 50,000 | |
| | To General Reserve A/c | | | 50,000 |
| | (Being amount transferred to general reserve — appropriation of profit) | | | |

# 🎯 Practice MCQs

**Q1.** According to AS-6 (Revised), depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from:

**A.** Use, effluxion of time or obsolescence through technology and market change

**B.** Inflation, market price fall, and abnormal accidents only

**C.** Decline in market value compared with book value

**D.** Loss on revaluation and impairment only

**Q2.** The original cost of a truck is ₹9,00,000 and its net salvage value after 16 years of useful life is ₹50,000. Using the WDV rate formula $R = [1 - \sqrt[n]{(s/c)}] \times 100$, the appropriate rate is approximately:

**A.** 8.3%

**B.** 16.6%

**C.** 25.0%

**D.** 33.3%

**Q3.** A machine is purchased for ₹50,000 and ₹5,000 is spent on its transportation and installation. Its useful life is 10 years and net residual value is ₹5,000. The annual depreciation under SLM will be:

**A.** ₹4,500

**B.** ₹5,000

**C.** ₹5,500

**D.** ₹6,000

# PYQ Alignment

This unit is one of the most frequently tested in CUET Accountancy — typically 6–8 MCQs per year. Question patterns include: numerical computation under SLM and WDV (the most common pattern), distinguishing depreciation from depletion / amortisation, identifying causes of depreciation, applying the WDV rate formula, distinguishing provision from reserve, identifying examples of capital vs revenue reserves, and assertion-reason questions on the non-cash nature of depreciation and the legal status of secret reserves. See `/pyq/accountancy` for drill sets.