

**Dr.SNS RAJALAKSHMI COLLEGE OF ARTS AND SCIENCE
(Autonomous)**

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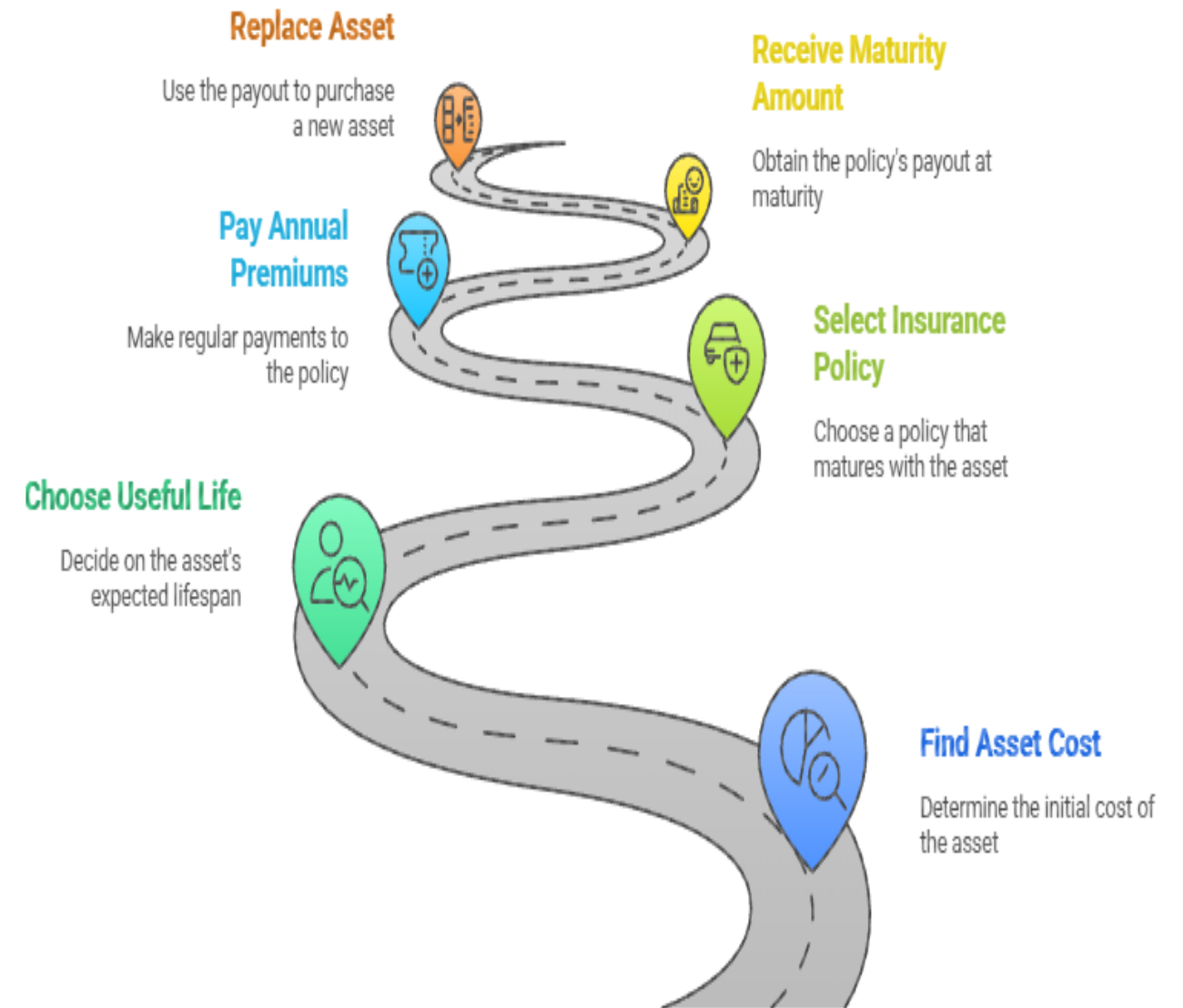
**DEPARTMENT OF COMMERCE WITH INFORMATION
TECHNOLOGY**

**21UCR402 – FUNCTIONAL ACCOUNTING
Unit-1: Depreciation- Insurance Policy Method**

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INSURANCE POLICY METHOD

- The Insurance Policy Method (also called the **Sinking Fund Method**) is a technique of providing depreciation where the business invests money in an insurance policy every year.
- The policy amount received at maturity is used to replace the asset when it becomes old.
- So instead of charging depreciation directly from profits, the business keeps aside a fixed annual premium.
- The policy accumulates value, and at the end of its term, the maturity value equals or nearly equals the cost of replacing the asset.



- **At the time of paying premium:**
 Insurance Policy A/c Dr
 To Bank A/c
- **At the end of each year:**
 Depreciation A/c Dr
 To Insurance Policy A/c
 (Annual premium treated as depreciation)
- **At maturity:**
 Bank A/c Dr
 To Insurance Policy A/c
- **Profit/ Loss on policy:**
 Insurance Policy A/c Dr / Cr
 To Profit and Loss A/c

JOURNAL ENTRIES

A machine costs ₹60,000 and has a life of 3 years.

The company takes an insurance policy that matures to ₹60,000 at the end of 3 years.

Annual premium = ₹18,000.

Calculate depreciation using the Insurance Policy Method.



SOLUTION

Depreciation per year = Annual premium = ₹18,000

Year	Premium Paid	Depreciation Charged	Balance in Insurance Policy A/c
1	₹18,000	₹18,000	₹18,000
2	₹18,000	₹18,000	₹36,000
3	₹18,000	₹18,000	₹54,000

At the end of Year 3, the policy matures, and the company receives **₹60,000**.

Profit on Policy

Amount received: ₹60,000

Policy account balance: ₹54,000

Profit = ₹60,000 – ₹54,000 = ₹6,000

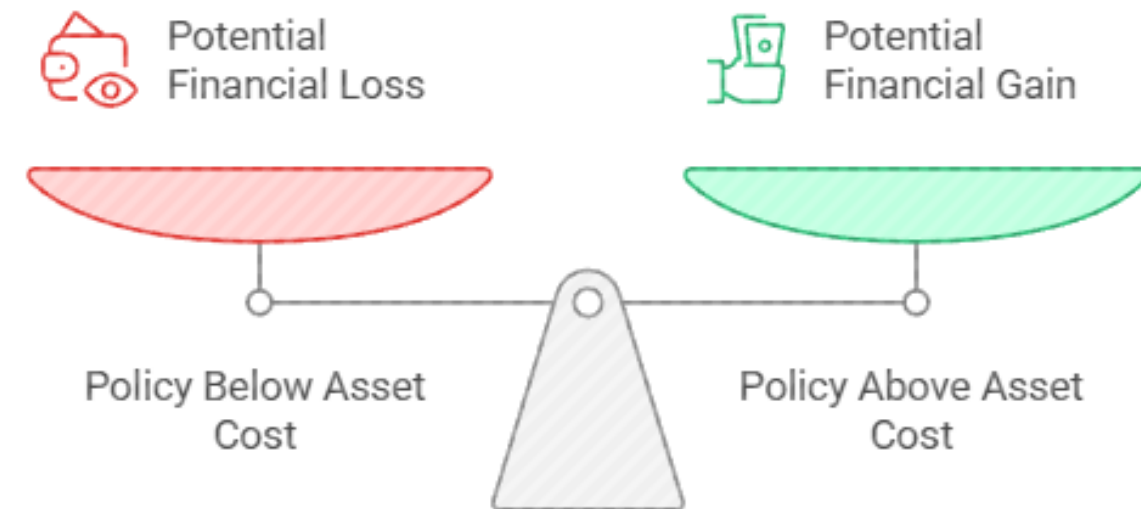
This profit is transferred to the **Profit and Loss Account**.

COMPARE POLICY OUTCOMES BASED ON COST OF THE ASSET

Here are **very clear examples** for both cases:

(1) Policy taken below asset cost and

(2) Policy taken above asset cost



Policy Taken Below Asset Cost

□ **EXAMPLE:**

Cost of Machine = ₹80,000

Useful Life = 4 years

Policy Maturity Amount = ₹70,000 (below asset cost)

Annual Premium = ₹16,000

□ **Depreciation**

Depreciation per year = Premium = ₹16,000

□ **At the end of 4 years**

Amount needed to buy new machine = ₹80,000

Amount received from policy = ₹70,000

□ **Loss on Replacement**

Loss = Cost – Maturity Value

Loss = ₹80,000 – ₹70,000 = ₹10,000

This ₹10,000 is debited to the **Profit & Loss Account**.

Policy Taken Above Asset Cost

Details

Cost of Machine = ₹80,000

Useful Life = 4 years

Policy Maturity Amount = ₹90,000 (above asset cost)

Annual Premium = ₹18,000

Depreciation

Depreciation per year = Premium = ₹18,000

At the end of 4 years

Amount needed to buy new machine = ₹80,000

Amount received from policy = ₹90,000

Profit on Replacement

Profit = Maturity Value – Cost

Profit = ₹90,000 – ₹80,000 = ₹10,000

This ₹10,000 is credited to **Profit & Loss Account**.

