



Accountancy Notes PDF

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Depreciation, Provisions and Reserves

(Class - 11 / Chapter- 7)

Depreciation is referred to as the reduction in the cost of a fixed asset in a sequential order due to wear and tear till the asset becomes obsolete. It refers to the period within which the asset can be considered to be productive. Beyond its useful life, the fixed asset is no longer considered to be cost-effective for continuing the operation of the asset.

Causes of Depreciation

- **By Constant Use-** When the fixed assets like a motor vehicle, machinery are used for a good amount of time, it manages to wear out
- **By Expiry of Time-** Due to natural calamities or elements of nature land may start to erode. Similarly, the machinery particles might start rusting
- **Outdated Technology-** The machine and the technology used today might be outdated and might have to be discarded

Need of Depreciation

- To provide an unbiased view of financial statements and not have inflated values reflected in financial statements. The assets' value in the market decreases with time. So, not keeping a tab on that in the books as well would be necessary to provide an accurate picture of profits or losses.
- For keeping money with the organization and not taking it away from the business. This is likely to happen when the profit is overestimated and is sent as dividends.
- To even out the profit and reflect true value keeping in consideration the production cost that comes with the deterioration in the value of an asset. This would ensure that the original value of the asset is not counted as the only expense.
- For replacing the old machinery with a new one by accumulating the charges for depreciation and using those when needed.
- To avoid paying extra to the government in tax. The business will have to pay extra tax unnecessarily in lieu of the wrong calculation of profit if depreciation is not accounted for. Thus, it is important to ensure scope to avoid any additional taxes.

Importance of Depreciation

- **For Ascertaining the True Profit or Loss-** The true profit of a company can be determined only when all the cost acquired is used to earn revenues is debited to the profit and loss account.
- **Showing Correct Financial Status-** When the depreciation is not imposed, the asset is recorded in the balance sheet at an amount which is excess of their actual value. In this case, the balance sheet does not present the actual financial status of a company.
- **To avoid excess payment of Income Tax-** Here, if the depreciation is not subtracted to the profit and loss account, the net profit shown will be surplus to the actual profit. Therefore, the company will have to pay extra income tax.

Factors Affecting Depreciation

- **Cost of Asset:** Depreciation is directly proportional.
- **Estimated Useful Life:** Determines the division of depreciation proportionately.
- **Estimated Scrap Value:** Identifies the net residual value and its direct correlation.

Methods of Calculating Depreciation

- Straight-line method
- Written down method

Meaning of Reserve

Reserves refer to the amount that is set aside out of profits and other surpluses to meet future uncertainties. In other words, a reserve is meant for meeting any sort of an unknown liability or losses in the future.

Types of Reserve

- **Revenue Reserve-** The share of the profits which is not paid to the owner or shareholders, and is kept reserved for operations or other demands, is known as a revenue reserve
- **Capital Reserve-** Capital reserve is the type of reserve that is created from capital profits. The purpose for which a capital reserve is created is for preparing the company for sudden events like inflation, business expansion, funds for a new project.

Meaning of Provision

The amount retained by way of providing for any unknown liability of which the amount cannot be detained with substantial accuracy.

Features of Provision

- Provision is arranged to meet a known liability
- The liability is known but the amount of these liabilities cannot be ascertained with reasonable accuracy
- Provision is a charge against profit and as such reduces the profits of the year in which it is created

Difference Between Provisions and Reserves

Basis	Provision	Reserve
Meaning	Maintained for a known liability	Maintained for an unknown liability
Nature	It is charged against profit	Appropriation of profit
Creation	Debiting P&L Account	Debiting P&L Appropriation Account
Need for Creation	If there is almost no profit in the business	Only if the business is reaping profits
Purpose	Specific Liability	Fortification of Business
Dividend Payment	Not used for dividend payments	Can be utilized for dividend payments as well

Difference Between Revenue Reserve and Capital Reserve

Basis	Revenue Reserve	Capital Reserve
Source	Daily operations	Profit from assets sold
Purpose	Business financial position is solidified	Long time projects can be financed, or capital expenses can be written off
Dividend	Can be paid as a dividend	Cannot be paid as a dividend

Difference Between General Reserve and Specific Reserve

Basis	General Reserve	Specific Reserve
Meaning	Created without a specific purpose in mind	Created with a specific purpose in mind
Usage	Flexible with being utilized wherever the business deems necessary	For the specification that has been kept in mind during the creation
Example	Fund reserve	DRR (debenture redemption reserve)

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