

DEPRECIATION, PROVISION AND RESERVE

In accounting parlance, 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- **Outdated Technology-** The machine and the technology used today might be outdated and might have to be discarded

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 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.

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 determined 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