

- Depreciation
- Provisions and Reserves

Depreciation

In every business, certain fixed assets such as buildings, plant and machinery, motor vehicles, furniture, and office equipment are essential for operations. These assets have a limited useful life, after which they lose their usefulness. The reduction in value and utility of these fixed assets due to usage and passage of time is called **depreciation**. It is the process of allocating the cost of a fixed asset over its useful life.

Definition of Depreciation

“Depreciation is the measure of the exhaustion of the effective life of an asset from any cause during a given period.” — **Spicer & Peglar**

“Depreciation is the gradual and permanent decrease in the value of fixed tangible assets from any cause.” — **R. N. Carter**

Features of Depreciation

- Depreciation is a permanent decline in the value of fixed assets (except land). Once reduced, the value cannot be restored to original cost.
- It is a gradual and continuous process caused by use, obsolescence, or time expiry.
- Depreciation is an allocation of cost, not a valuation of the asset.
- It decreases only the book value, not the market value.
- Applicable only to tangible fixed assets, not wasting assets like mines or oil wells.
- It is a non-cash expense and does not involve cash outflow.

Causes of Depreciation

- Constant use

- Expiry of time
- Expiry of legal rights
- Obsolescence
- Accident
- Depletion
- Permanent fall in market price

Factors Affecting Depreciation

Actual depreciation cannot be precisely calculated but estimated considering:

- Total cost of the asset
- Estimated useful life of the asset
- Estimated scrap value at the end of useful life

Methods of Depreciation

- Straight Line Method (SLM)
- Written Down Value Method (WDV)

Difference between SLM and WDV

The Straight Line Method charges an equal amount of depreciation each year over the asset's useful life, while the Written Down Value Method charges depreciation at a fixed percentage on the reducing book value each year. SLM results in constant depreciation expense annually, whereas WDV results in decreasing depreciation amounts over time.

Advantages of Straight Line Method

- Simple to understand and apply.
- Asset value can be fully written off by the end of its useful life.
- Facilitates easier profit comparison due to equal depreciation charges.
- Suitable for assets with consistent usage.

Advantages of Written Down Value Method

- Simple and easy to operate.
- Depreciation amount reduces as asset value decreases.
- Higher depreciation in earlier years when asset efficiency and repair costs are low.

Methods of Recording Depreciation

- Charging depreciation directly to the Asset Account.
- Creating a Provision for Depreciation account.
- Treatment of depreciation during disposal of asset.

Key Terms

Depletion: Physical deterioration due to exhaustion of natural resources like mines or oil wells. Depreciation is charged based on quantity produced.

Amortisation: Writing off the cost of intangible assets such as patents, copyrights, trademarks, franchises, and leasehold mines over their useful life.

Obsolescence: Loss of asset value due to technological advancements making assets outdated.

Provisions and Reserves

Provisions

Provisions are amounts set aside from profits to meet known liabilities of uncertain amounts. Examples include:

- Provision for bad and doubtful debts
- Provision for depreciation
- Provision for taxation
- Provision for discount on debtors

Reserves

Reserves are created from profits to strengthen the financial position and support future growth. They are classified as:

Revenue Reserve

Created from revenue profits earned from normal business activities. It can be general or specific.

- **General Reserve:** Created without any specified purpose.
- **Specific Reserve:** Created for a specific purpose, e.g., Debenture Redemption Reserve, Investment Fluctuation Reserve, Dividend Equalisation Reserve, Workmen Compensation Fund.

Capital Reserve

Created from capital profits arising from non-operating activities such as sale of fixed assets. Examples include:

- Premium on issue of shares
- Premium on issue of debentures
- Profit on redemption of debentures
- Profit on sale of fixed assets
- Profit on reissue of forfeited shares

- Profit prior to incorporation

Difference Between Capital and Revenue Reserve

Revenue Reserve is created from regular business profits and can be used for general or specific purposes, including dividend distribution. Capital Reserve arises from capital profits and is used only for specific purposes; it cannot be distributed as dividends.

Key Terms

Open Reserves: Reserves shown on the liabilities side of the balance sheet.

Secret Reserve: Reserves not shown in the balance sheet and kept confidential.

Reserve Fund: Reserves invested outside the business in securities.

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