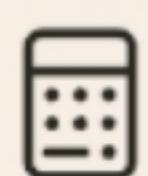




Understanding Depreciation & Amortization

Today, we will explore **Depreciation** and **Amortization**, two key accounting concepts used to allocate the cost of assets over their useful life. Understanding these concepts helps in assessing the **true profitability** of a business and the **value of its assets** over time.

What is Depreciation?



Definition

Depreciation is the **systematic allocation** of the cost of a **tangible fixed asset** (like machinery, vehicles, or buildings) over its useful life. It reflects how much of the asset's value has been **used up** each year.



Importance

Reflects the **wear and tear** or obsolescence of assets.

Helps in **accurate profit calculation** by distributing the cost over time.

Reduces taxable income, offering **tax benefits**.

Example: If you buy machinery for ₹10,00,000 with a useful life of **10 years**, you cannot expense the entire cost in the first year. Instead, you **depreciate** it over time to reflect its usage.

What is Amortization?

❖ **Definition:** Amortization is the process of allocating the cost of **intangible assets** (like patents, copyrights, or trademarks) over their useful life.

Why is Amortization Important?

- Reflects the **gradual consumption** of intangible assets.
- Helps accurately report **net income**.
- Similar to depreciation but for non-physical assets.

💡 **Example:** A company buys a patent for ₹5,00,000 with a useful life of **5 years**.

Amortization expense = ₹1,00,000 per year.

Straight-Line Method (SLM)

❖ **Definition:** In the **Straight-Line Method**, the cost of an asset is **depreciated equally** over its useful life.

Formula:

$$\text{Annual Depreciation} = (\text{Cost of Asset} - \text{Salvage Value}) / \text{Useful Life (Years)}$$

Explanation:

- Suitable for assets that provide **consistent benefits** over time.
- Simple and widely used method.

💡 **Example:** You buy machinery for ₹10,00,000, with a **salvage value of ₹1,00,000** and a **useful life of 9 years**.

$$\text{Annual Depreciation} = (\text{₹10,00,000} - \text{₹1,00,000}) / 9 = \text{₹1,00,000}$$

Depreciation of ₹1,00,000 is charged every year for 9 years.

Reducing Balance Method (RBM)

 **Definition:** In the **Reducing Balance Method**, depreciation is charged at a **fixed percentage** on the **book value** of the asset each year.

Formula:

Depreciation = Book Value at the Beginning of the Year ×
Depreciation Rate (%)

Explanation:

- Higher depreciation in **earlier years** and lower in later years.
- Suitable for assets that **lose value quickly**, like electronics or vehicles.

 **Example:** You buy machinery for **₹10,00,000** with a depreciation rate of **20%**.

RBM Example Calculation

Year	Book Value (Start)	Depreciation (20%)	Book Value (End)
1	₹10,00,000	₹2,00,000	₹8,00,000
2	₹8,00,000	₹1,60,000	₹6,40,000
3	₹6,40,000	₹1,28,000	₹5,12,000

Depreciation expense reduces every year.

Advantages:

- Reflects **actual usage** or wear of the asset.
- Provides **tax benefits** by deferring taxes in early years.

Disadvantages:

- Complex to calculate.
- Not suitable for assets that depreciate **uniformly** over time.

Key Differences Between Methods

Feature	Straight-Line Method	Reducing Balance Method
Calculation Basis	Based on original cost of the asset.	Based on book value each year.
Depreciation Amount	Fixed every year.	Declines every year.
Best For	Assets with consistent usage .	Assets that wear out faster in early years.
Impact on Profitability	Steady impact on profits.	Higher impact in early years.
Example	Buildings, furniture.	Vehicles, electronics.

Business Benefits of Depreciation & Amortization



Reflects Asset Value

Shows the current book value of assets.



Reduces Taxable Income

Depreciation is a non-cash expense that lowers taxes.



Accurately Measures Profit

Spreads the cost over time, preventing overstatement of profits.



Helps in Capital Budgeting

Determines when to replace or invest in new assets.

 **Business Impact Example:** If a company buys expensive equipment for ₹1 crore, charging the full amount as an expense in one year would **drastically reduce profits**. Depreciation spreads the cost over time, showing a **more accurate profit trend**.

Amortization vs. Depreciation

Feature	Depreciation	Amortization
Asset Type	Tangible assets (machinery, buildings).	Intangible assets (patents, trademarks).
Purpose	Allocates cost over useful life.	Allocates cost over legal or useful life.
Method Used	Straight-line or reducing balance.	Mostly straight-line method.
Impact on Taxes	Reduces taxable income.	Reduces taxable income.
Example	Factory equipment, vehicles.	Patent on a new product.

Real-World Applications & Key Takeaways

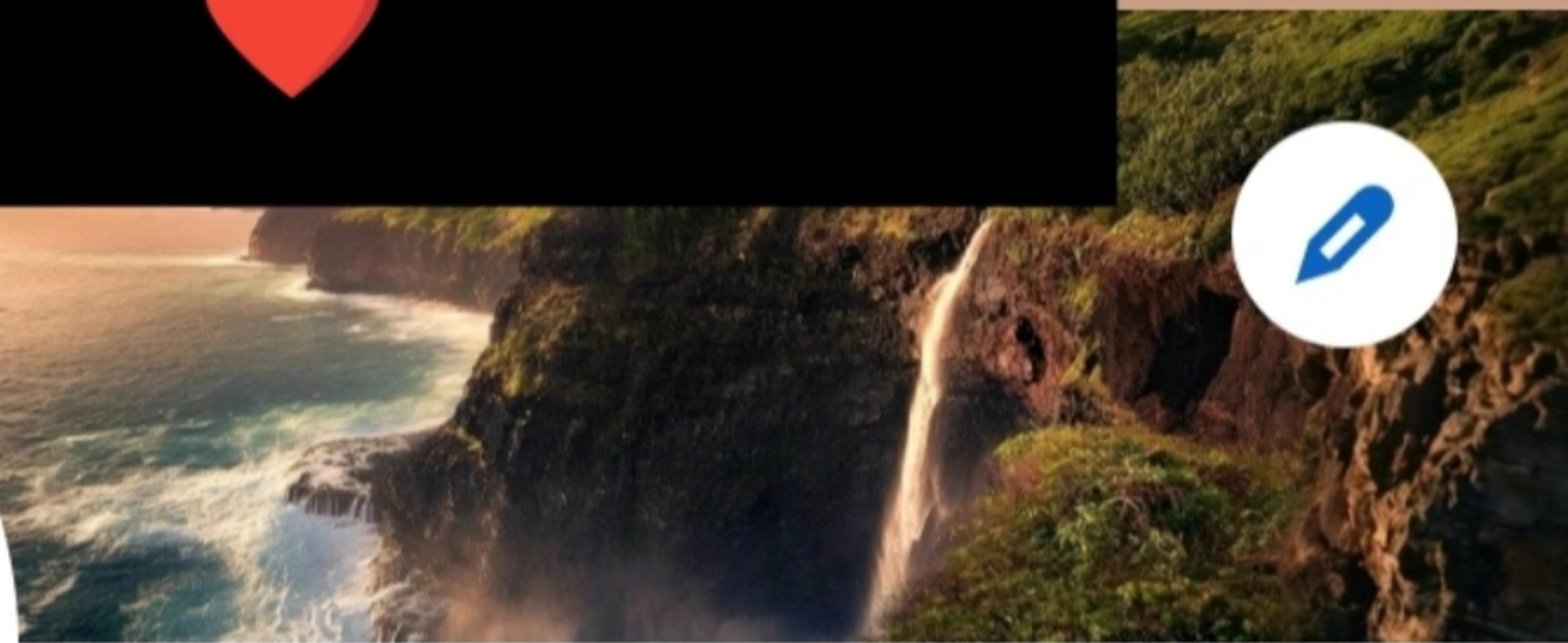
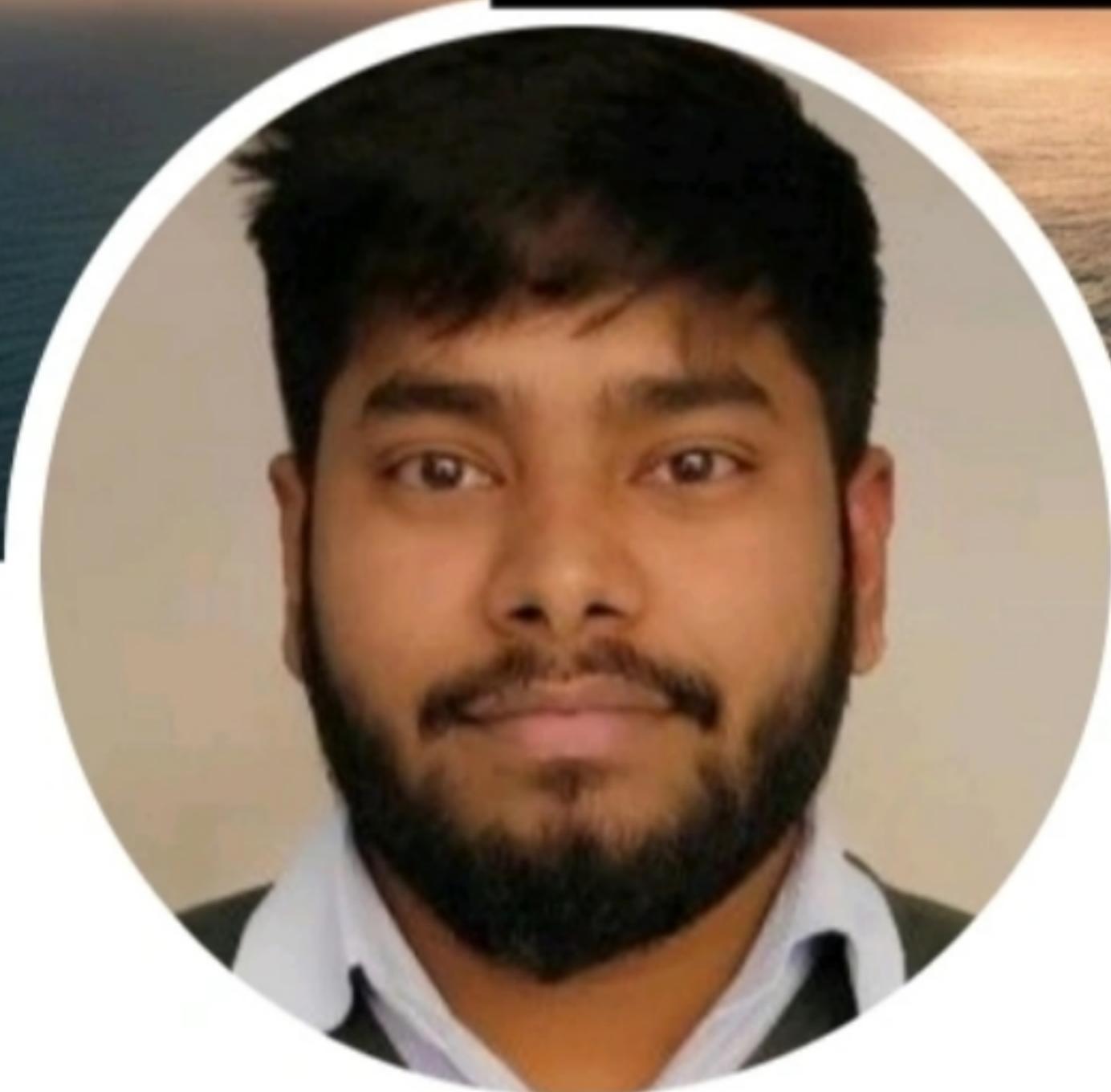
Real-World Applications

- **Manufacturing Companies:** Depreciate machinery and equipment to show accurate profit margins.
- **Technology Firms:** Amortize patents and software licenses over their useful life.
- **Automotive Industry:** Uses reducing balance for vehicle depreciation.
- **Real Estate:** Uses straight-line depreciation for buildings.

Key Takeaways

- **Depreciation** is for tangible assets; **Amortization** is for intangible assets.
- **Straight-line method** is simple and suitable for assets with consistent usage.
- **Reducing balance method** charges more depreciation in early years.
- Both methods help **accurately reflect asset value** and **reduce taxable income**.
- Choosing the right method depends on the **nature of the asset** and **business strategy**.

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