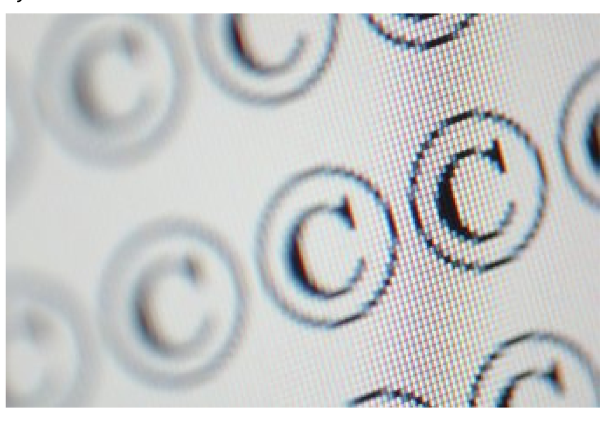
How to Generate Cash From Depreciation and Amortization

by Jonathan Lister



Depreciation and amortization both represent reductions in the value of your small business assets, though each pertains to a different category of asset. Using depreciation and amortization properly can help your small business generate cash through recouping the costs of purchasing capital assets, as well as by reducing tax liability with the federal government.

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Definition of Depreciation

Depreciation is the loss of value in fixed assets over time. This means what your company paid for equipment last year is not the price you could net by selling that same equipment in a future year. As a business owner, your company's fixed assets lose value annually for a variety of reasons, including wear and tear from daily use, invention of more efficient equipment models and damage to working parts. Not every piece of equipment in your small business is an asset. Only items integral to your company's essential operations are assets for the purposes of depreciation. For example, a restaurant would consider its ovens, grills and point of sale systems as business assets subject to depreciation.

Definition of Amortization

Amortization functions in a similar way to depreciation, but it applies to different areas of your small business. According to the Business Dictionary's website, amortization is the writing off of intangible company assets over time, as these assets relate to operational costs. Intangible assets your small business may amortize over time may include patents, copyrights, trademarks and even goodwill among consumers. This allows your company to reduce expectations on profit levels due to sinking demand for certain products and expanded competition in the market due to expiring patents.

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Importance for Income Statements

Amortization and depreciation appear on your small business's annual income statement. In accounting terms, these two types of asset reduction generate income by omission rather than outright expansion of profits through customer purchases. This is because your business has already paid the cost to purchase the tangible assets or intangible properties on a previous income statement, according to the "Fundamentals of Financial Management," written by Eugene F. Brigham and Joel F. Houston. Your small business gets to reduce its gross income while incurring no additional cost for depreciation or amortization, even though reporting these two categories on your company's income statement might make them appear as profit on the surface.

Business Tax Deductions

When it comes to paying taxes on your tangible and intangible business assets, the IRS provides your company with a means of generating cash by subtraction in a similar way as your income statement. You may use the rate of depreciation for your capital business assets as a business deduction on your federal return. This allows you to slowly recoup the original purchase price of your capital and intangible assets over time using the Modified Accelerated Cost Recovery System.

References (3)

- IRS.gov: A Brief Overview of Depreciation
- BusinessDictionary.com: Amortization
- Fundamentals of Financial Management; Eugene F. Brigham and Joel F. Houston

About the Author

Jonathan Lister has been a writer and content marketer since 2003. His latest book publication, "Bullet, a Demos City Novel" is forthcoming from J Taylor Publishing in June 2014. He holds a Bachelor of Arts in English from Shippensburg University and a Master of Fine Arts in writing and poetics from Naropa University.

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