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A STUDY ON EFFECT OF DEPRECIATION METHODS ON NET PROFIT OF BUSINESSES

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ABSTRACT

The basis for depreciation expense is management's estimation of the useful life of the company's assets. Depreciation is a non-cash expense capitalized over the useful life of the company's plant and equipment. By lengthening or shortening its estimate of the useful life of its assets, the company can increase or decrease depreciation expense, thereby affecting its net profit margin. The method of accounting plays an important role in determining profitability of the business. Our study mainly focuses on three mostly used depreciation policies by corporate and their effect on their profitability.

KEYWORDS

depreciation accounting, asset management.

INTRODUCTION

Companies generally implement adequate asset management procedures to ensure that accounting statements are accurate and complete. An asset is an economic resource that an organization owns or on which it can claim ownership at a future date. Depreciation ensures that a company allocates costs associated with corporate assets in financial reports, particularly in the statement of profit and loss.

IDENTIFICATION

Depreciation is an accounting practice that enables organizations to spread the costs of long-term assets over several years. Long-term assets are also referred to as fixed or capital resources, and include real estate, plants and equipment. Straight-line and accelerated methods are the most common depreciation techniques. Both methods affect a company's net profit because depreciation is an operating expense. Net profit, or net income, equals corporate revenues minus expenses.

TYPES

- i) **Straight-line:-** It first calculates the depreciable base (cost less salvage) before dividing it by number of years (life of machine) to arrive at annual rate of depreciation. The **straight-line method** is the most straightforward method of Asset Value Depreciation. But not all equipment deteriorates equally e.g. a car, over its useful life. Methods based on actual usage: total life is too cumbersome to be practicable

Cost of Machine + Installation + Directly Associated Costs = Total Cost

Total Cost - Salvage Value (At end of 10 yr. Period) = Depreciable base

- ii) **Declining Balance Method:-** The declining balance depreciation method is an accelerated method since a large part of the cost of the fixed asset is expensed at the beginning of the life of that asset. To calculate declining balance depreciation the depreciable basis of the fixed asset is multiplied by a factor. The depreciable basis is the book value of the fixed asset -- cost less accumulated depreciation.

The factor is the percentage of the asset that would be depreciated each year under straight line depreciation times an accelerator. For example, an asset with a five year life would have 20% of the cost depreciated each year. If the accelerator is 200% then the factor would be 40% (20% x 200%). The 200% accelerator is referred to as double declining balance and is the most common.

- iii) **WDV Method:-** written down value, applicable to machines that have high rates of depreciation in the initial year or two, and later taper it e.g. a car, is a usable method.

Under this method, depreciation is charged at a fixed rate every year, on the reducing balance. A certain percentage is applied to the previous year's book value, to arrive at the current year's depreciation/ book value, which shows a declining balance, weighted for earlier years, and lower and lower for later years, as the machine grows older. It accelerates depreciation taken in early years and reduces the amount taken in later years. It ignores salvage value and starts with depreciable base = asset cost.

These methods affect net profit in different ways. In a straight-line process, a corporate bookkeeper records the same depreciation amount evenly over the asset's useful life—that is, the period over which management believes the asset will serve in operating activities. If a company opts for an accelerated method, the bookkeeper records higher depreciation amounts in earlier years.

CALCULATIONS

Comparing Depreciation Methods					
Method	Year 1	Year 2	Year 3	Year 4	Year 5
Straight Line	200000	200000	200000	200000	200000
WDV	200000	160000	128000	102400	81920
Declining Balance Methode	400000	240000	144000	86400	51840

SIGNIFICANCE

As a business practice, depreciation plays an important role in long-term decision-making processes. Corporate leadership pays attention to depreciation methods because they affect not only net profit but other key financial indicators such as operating income and working capital. Operating income equals gross revenues minus materials costs. Working capital gauges short-term cash availability and equals current assets minus current liabilities. A company's depreciation policies also affect its fiscal liability, as Internal Revenue Service depreciation guidelines generally differ from financial accounting rules.

IMPACT ON NET PROFIT

As an operating expense, depreciation affects net income. For example, a large car-seat manufacturer depreciates its fixed assets using a straight-line method. In total, the company's assets are worth Rs. 10,00,000/-, and their average useful life is 5 years. Accordingly, total annual depreciation equals Rs. 2,00,000 (Rs. 10,00,000 divided by 5), and the firm's annual net profit will decrease by the same amount. Assuming the controller selected a "50-30-20 accelerated method," total depreciation for the first year would be Rs. 5,00,000 (50 percent of 10,00,000/-). As a result, the company's net profit would decrease by Rs.5,00,000.

CONCLUSIONS

In addition to net profit, depreciation methods also affect other financial indicators and accounting reports. These financial statements include balance sheets or statements of financial position, statements of cash flows and statements of retained earnings. Although it impacts net income, depreciation is a noncash item, meaning a company does not pay for it. Many companies choose straight-line method for reporting depreciation to shareholders because net income is higher in early year. Because net income is lower in early years, some companies prefer the written down value method, especially for Income Tax purposes.

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