



Subject : Business Finance II

Depreciation & Reserves

Depreciation – Break Down

1. It's a **Charge**
2. On a **year-on-year** basis (Non-Current / Long Term Asset)
3. For **normal wear and tear**
4. On the value of an **long term** asset

Note: Any fall in price would not mean depreciation. But only that fall in price generated by normal wear and tear is considered as depreciation

Depreciation (Car, Machine, etc)

- Depreciation adjustments are required because virtually all non-current assets have **finite useful economic lives**.
- Depreciation is defined as the measure of the wearing out, consumption or other reduction in the useful economic life of a non-current asset, whether arising from:
 - the passage of time, or
 - obsolescence through technological or market changes
- Not attempt to reflect the value of non-current assets in the statement of financial position. Rather, the purpose is to charge the purchase price of the company's non-current assets in the statement of profit or loss in a systematic way
- Depreciation is an application of the matching concept

Dep – Accounting Entry

1. Depreciation (Non-Cash Expense) – highlighted in your Statement of Profit and Loss
2. Reduces the value of the asset in your Balance Sheet by the amount of depreciation charged

Components (Tesla Car)

- Cost of Purchase – Rs. 50 lakhs (Fact)
- Useful Life – 8 years (Estimate)
- Rate of Depreciation (Defined by Companies Act / Income Tax Act in India)
- Residual Value – Rs. 10 lakhs (Estimate)
- Method of Depreciation – Straight Line Method / Residual Value Method
(Accounting Policies defined by the Company itself)

Method of Depreciation

Straight Line Method:

- The straight line basis can also be expressed by charging a percentage of cost.
 - Cost of Purchase – Rs. 50 lakhs (Fact)
 - Dep Rate – 20%
 - Residual Value – Rs. 10 lakhs (Estimate)

Method of Depreciation

Reducing Balance Method:

- This charges a fixed percentage of 'book value' (ie cost less depreciation to date) each year so that the whole cost is charged over the life of the asset

Year	Book value at start of year	Depreciation	Book value at end of year
1	1,000	370	630
2	630	233	397
3	397	147	250
4	250	92	158
5	158	58	100

Comparison

- One advantage of the reducing balance method is that it tends to charge a heavier proportion of the cost of the assets when they are new. This might make the depreciation charge in the statement of profit or loss more relevant because most of the charge will be based on the cost of newer, more recent assets.

Practical Reporting Framework

	Freehold Land and buildings	Leasehold Land and buildings	Plant and Machinery	Total
	£000	£000	£000	£000
Cost or Valuation				
1 January 20X0	200	100	50	350
Additions	10	2	4	16
Disposals	(7)	(6)	(8)	(21)
31 December 20X0	203	96	46	345
Depreciation				
1 January 20X0	30	20	16	66
Charge for year	4	8	5	17
Disposals	(3)	(2)	(4)	(9)
31 December 20X0	31	26	17	74
Net Book Value				
31 December 20X0	172	70	29	271
1 January 20X0	170	80	34	284

Capital and Reserves

- The statement of financial position lists the assets owned by the company and the liabilities which are owed to third parties. The residual amount is called capital or equity and belongs to the shareholders

Share Capital and Share Premium

- Shares carry a 'nominal' value for bookkeeping purposes. This does not, however, necessarily reflect the market value of the company and it is possible that the company will be able to find buyers who would be willing to pay rather more.

The share premium account can also be used for:

- the preliminary expenses of forming a company
- the expenses and commissions incurred in any issue of shares
- any profit or loss on the issue of loan stock
- any premium paid on the redemption of loan stock
- the expenses of issue of loan stock.

Amortisation (Equivalent to Depreciation but for intangible assets)

License from Pfizer to manufacture and sell its vaccine for **1 years**

License Fee of US\$5 billion (Right to manufacture and sell vaccines)

Asset

Intangible Non-Current Assets

License Fee – US\$ 5 billion (Expense in P&L)

(-) **Amortisation** US\$500mm $[(5\text{bn} - 0)/10]$

Revaluation Reserve

- Despite the cost concept, it is common practice to revalue land and buildings in the statement of financial position
- The amount of the revaluation reserve is included in 'Other reserves' in the statement of financial position

	Building Premise	Mkt Values
Cost (5 years back)	20 cr	20 cr
(-) Total Dep	(5 cr)	
As on Today - Book Value:	15 cr	22 cr
Revaluation Reserve (exception to the Prudence concept)	+ 7 cr	
	22 Cr	22 Cr

Treatment of Revaluation Reserve:

Increase the value of the Asset

Create a Revaluation Reserve in the Equity section of your liabilities side

Thank You