UNDERSTANDING ASSET DEPRECIATION

http://www.sideroad.com/Accounting/asset-depreciation.html

Depreciation is defined as a portion of the cost that reflects the use of a fixed asset during an accounting period. A fixed asset is an item that has a useful life of over one year. An accounting period is usually a month, quarter, six months or one year. Let's say you bought a desk for your office on January 1, for $1000 and it was determined that the desk had a useful life of seven years. Using a one year accounting period and the "straight-line" method of depreciation, the portion of the cost to be depreciated would be one-seventh of $1000, or $142.86.

Most non-accountants roll their eyes and shudder when the topic of "depreciation" comes up. This is where the line in the sand is drawn. Depreciation is far too complicated to try and figure out, or so it seems to many. But is it really? Surely the definition of depreciation mentioned above is not that difficult to comprehend. If you look closely you will see that there are five pieces of information you must have in order to determine the amount of depreciation you can deduct in one year. They are:

- The nature of the item purchased (the desk).
- The date the item was placed in service (Jan 1).
- The cost of the item ($1000).
- The useful life of the item (seven years).
- The method of depreciation to be used (straight-line).

The first three are easy to figure out, the second two are also easy but require a little research. How do you figure out the useful life of an item? Let me regress for a moment. There is "book depreciation" which is based on the real useful life of an item, and there is the IRS version of what constitutes the useful life of an item. A business that is concerned with accurately allocating its costs so that it can get a true picture of net profit will use book depreciation on its financial statements.

However, for tax purposes the business is required to use the IRS method. The IRS may have shorter or longer useful lives for fixed assets causing a higher or lower depreciation write-off. The higher the write-off, the less tax a business pays. The long and short of it is that you end up having to create a book financial statement and a tax financial statement. So, most small businesses that aren't concerned with a precise measurement of their net profit use the IRS method on their books. This means that all you have to do is look in IRS Publication 946 to find the useful life of a particular item.

The last piece of information you need is found by determining the method of depreciation to use. Most often it will be one of two methods: the "straight-line" method or an accelerated method called the "double-declining balance" method. Let's briefly discuss these two methods:

1. Straight-line - This is the simple method mentioned in the definition above. Just take the cost of the item, divide it by the useful life and you've got the answer. Yes, you will have to adjust the depreciation for the first year you placed the item in service and for the last year when you removed the item from service. For instance, if your depreciation for one year was $150 and you placed the item in service on April 1 then divide $150 by 12 (months) and multiply $12.50 by 9 (months) to get $112.50. If you removed the item on February 28 then your deduction will only be $25.00 (2 x $12.50).

2. Double-declining balance - The idea behind this method is that when an item is purchased new, you will use up more of it in the earlier years of its life, therefore, justifying a higher depreciation deduction in the earlier years. With this method, simply divide the cost of the item by the useful life years as in the straight-line method. Then, multiply that result by 2 (double) in the first year. The second year, take the cost of the item and subtract the accumulated depreciation. Next, divide that result by the useful life and multiply that result by 2, and so on for each remaining year.

But, wait! You don't have to do this. The IRS provides tables that have the percentages worked out for each year of the two different methods. Not only that, they have set up special first year "conventions" that assume you purchased your depreciable fixed assets on June 30. This is called the one-half year convention. The idea behind this is that you may have bought some items earlier than June 30 and some after that date. So, to make it easy to figure out, they assume the higher and lower depreciation amounts will all average out.

Actually, the IRS doesn't even call it depreciation anymore. They call it "cost recovery". Let's face it. This is a political tool. Congress giveth and taketh away. They have been playing with this system for years. If they want to stimulate growth in business they will shorten the useful life of assets so businesses can attain a higher write-off. If they are not in the mood, they will extend the useful life of an item. A good example is the 39 years set for the useful life of commercial property. This means that if you lease a building for your business and make improvements, those improvements have to be depreciated over 39 years. The House has just approved a bill to drop that down to 15 years for leasehold improvements, but the Senate hasn't yet approved it.

Before December 31, 1986 we had ACRS or Accelerated Cost Recovery System. Currently, we have MACRS or Modified Accelerated Cost Recovery System. Every time congress tweaks the rules they give it a different name.

Keep in mind there are different schedules for different properties. For instance, residential real property is depreciated over twenty-seven and one-half years and non-residential real property is depreciated over thirty-nine years. In addition, if more than forty percent of your total fixed asset purchases occurred in the last quarter of the year, then, you must use a mid-quarter convention. This convention assumes that your purchases made in the last quarter of the year were made on November 15. This prevents you from buying a big expensive piece of equipment on December 31 and treating it as though it were purchased on June 30 and gaining a larger depreciation expense.

Understanding how basic depreciation works can be valuable to the small business owner because it helps to know the tax implications when planning for capital equipment purchases.