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**Understanding Depreciation**

Depreciation can be a tricky topic to understand for small business owners. It doesn’t affect cash, but it does affect your profits. It also affects how much tax you pay. Let’s dive in with a simple explanation of depreciation for accounting purposes.

**Large Purchases**

When you purchase a car or piece of equipment for your business that will last for many years, it takes quite a bit of cash. The car or equipment is going to last many years and benefit your business over many years, not just the current one.

In accounting, we try to match the timing of when something is useful to when it affects your profits. This is called the matching principle. Rather than immediately expense this asset that’s going to help your business over many years, it makes sense to expense portions of it over the time you use it. Otherwise, your business would show a huge loss in one year and excessive gains in subsequent years. This is the concept behind depreciation.

Let’s say you bought a piece of equipment for $20,000 that will last five years. With depreciation, you can expense $4,000 per year for five years, spreading out the benefits of the machine against the revenues it is helping you earn.

**Useful Life and Salvage Value**

To standardize the way all businesses handle depreciation, each asset is assigned a useful life based on its asset class. We won’t go into these details here, but your accountant will have a table that they use to calculate the right amount of depreciation for the assets you purchase in your business.

Some assets will also have a value at the end of their life. This is called salvage value. In the above example, we assumed it was zero.

**Depreciation Methods**

There are many methods to come up with the amount to use for depreciation. The above example uses a method called straight line, and there is a formula attached to each method. This is the formula for calculating straight-line depreciation:

*Annual Depreciation Expense = (Asset Cost – Salvage Value) / Asset’s Useful Life*

Other depreciation methods that are accepted include double declining balance, units of production, and the sum of the years’ digits, plus more than half a dozen others. Each comes with its own formula.

**How Cash Is Affected**

While cash may be affected in the year of the asset’s purchase, depreciation is a non-cash expense. This confuses many small business owners and is one of many things that causes the amount of profit to differ from the amount of cash on hand.

**Land and Other Exceptions**

If your company owns land, it is recorded on your balance sheet as an asset.  While it certainly benefits your business over time, it is an exception to the depreciation rule. Land is not depreciated. Any buildings on the land are depreciated. The reasoning is that land doesn’t lose its value over time and does not need to be replaced like other assets.

Only physical assets expected to benefit the company for more than a year are depreciated. Most of these fall into a category called fixed assets. To avoid costly accounting expense, these assets also must be substantial in cost (or material, as we say in accounting). A pencil might last longer than a year, but office supplies are too inexpensive to depreciate. There is a limit on the value of what is cost-effective to depreciate.

**The Journal Entries**

A sample simplified journal entry to record the initial purchase of an asset looks like this:

**Debit Fixed Asset** (either the asset is named and an account created for that asset or a separate detailed fixed assets schedule is maintained to keep the chart of accounts cleaner)

**Credit Cash or Loan or both**

To record depreciation in the first year, a contra-asset account is set up. A contra-asset account is an asset account with a negative, or credit, balance.

**Debit Depreciation Expense**

Credit Accumulated Depreciation (a contra-asset account)

The Fixed Assets portion of your balance sheet is where these accounts would go:

* **Asset**
* **Accumulated Depreciation** (this is the contra account)

For small businesses, depreciation can be figured once a year as an adjusting entry to save bookkeeping time throughout the year. Or it can be figured more often so there are no surprises with the amount of profit the company is making.

**Taxes versus Book Depreciation**

For tax purposes, depreciation is a huge topic. Many times, it’s beneficial for a company to write off depreciation faster, so fewer taxes are due. Currently, there are tables provided by the IRS as well as maximum depreciation limits. Right now, there is bonus depreciation (until the 2026 tax year) as well.

Large businesses may use one method for depreciation for their accounting records to investors, and another depreciation method for tax purposes to reduce taxes.

Depreciation is a massive topic, yet a simple concept. Your accountant can help you with the nuts and bolts of depreciation so that you have a plan that’s best for your business.

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