What Is Depreciation

Idea In Short

Understand depreciation as both economic value loss and accounting cost allocation. The cash is already spent, so depreciation is a non-cash expense that spreads that cost over the asset's useful life. Know the IRS schedules, the $2,500 expensing threshold and why EBITDA can mislead.

Two Meanings of Depreciation

Depreciation has two meanings that every consultant and executive should understand. The first is the common-sense definition most people know intuitively. The second is the financial accounting definition that dictates how the costs of fixed assets are spread over many years. Knowing the difference prevents costly misunderstandings in financial analysis.

Economic Depreciation: Things Go Down in Value

Economic depreciation is no surprise. It is just the opposite of appreciation. Think about your car, your computer or your roof. The older stuff gets, the more worn out it becomes and the less valuable it is. Old stuff gets worn out and less useful. They say a new car depreciates about 20 percent the minute you drive it off the dealer's lot.

The same applies to real estate. If you bought a home in Las Vegas in late 2006, the average house fell from $298,000 to $194,000 by 2016. Rental properties can provide good cash flow and a solid return on equity, but you should not count on capital appreciation because values can depreciate too. If prices go up, good for you. Just do not bet your retirement on it.

Accounting Depreciation: Allocating Cost Over Time

Accounting depreciation refers to the costs of a fixed asset being allocated over several years. A fixed asset is something that lasts many years, like equipment or a building. During

MBA coursework, we learn the matching principle, which says to allocate revenues and costs to the time period when they occur. That is why we have deferred liabilities and accrued expenses. Depreciation allocates costs with revenues, but it is a non-cash expense because the money was already spent.

As an example, if you buy a piece of equipment for $70,000 that will last 10 years, you divide the cost by 10. For tax purposes, you can only deduct $7,000 of depreciation expense annually. In terms of cash flow, you spent $70,000 already, but your financial statements will only show a $7,000 depreciation expense in year one. The only upside is that you get $7,000 in expense in years two through 10 until the asset is fully depreciated.

Non-Cash Expense and Profitability

Depreciation tends to understate profitability in the early years and overstate it later on. On the balance sheet, this also gives a more accurate, albeit still flawed, estimate of the salvage value. After year four, you have taken $28,000 in depreciation expense, and the remaining salvage value is $42,000. This gradual recognition matches the expense to the periods that benefit from the asset.

The key insight is that depreciation does not reflect cash flow. The cash left your account when you bought the asset. Depreciation simply recognizes that cost over time for accounting and tax purposes. Understanding this distinction is essential for anyone reading financial statements or building financial models.

How Many Years to Depreciate

The U.S. government provides schedules that tell you the expected average life of an asset for tax purposes 1. It is approximate and imperfect, but at least it is consistent for taxes. For rental properties, the duration can vary from 5 years for carpets and appliances to 27.5 years for roofs and buildings. For agricultural assets, the duration can vary from 3 years for hogs and tractors to 15 years for drainage facilities to 39 years for non-residential buildings.

If you buy a $1,000 refrigerator, you expense the cost over 5 years as an appliance. You cannot take a $1,000 deduction immediately. You must expense $200 annually for 5 years, taking the accounting depreciation and chopping it into pieces that the IRS says you can expense each year. This has nothing to do with how long the refrigerator actually runs. That beautiful appliance might last 15 years.

Last year, I bought two air conditioning units for rental properties. They cost about $4,000 each, and my certified public accountant said the units had to be depreciated over 27.5 years. I was frustrated. Those units will not last that long. My CPA was clear: that is what the government schedule says, and that is how much I can expense. I spent $8,000 out of pocket but can only expense $291 of it in year one.

Depreciate or Expense

As someone who owns rental properties, I would rather expense costs than depreciate them. I have already spent the money. Would I rather reduce my taxable income today or slowly over time? Absolutely, deduct now. The difference between expensing and depreciating has real cash flow implications for small business owners and investors.

The IRS raised the maximum amount you can deduct as an expense from $500 up to $2,500. If you are under that amount, deduct it immediately. If you are over $2,500, it becomes a depreciating asset and you only get to deduct a fraction of the cost based on the asset's average life. Remember that $2,500 is the threshold. Larger companies with audited financials can expense up to $5,000.

What Happens If You Replace Early

If the equipment goes bad before the depreciation schedule ends, you can expense the remaining cost when you throw it away. This is a small consolation, but it means you are not permanently locked into a schedule that no longer reflects reality. The remaining book value becomes deductible in the year you dispose of the asset.

Accelerated Depreciation

The government offers different methods for depreciating assets. Straight-line depreciation simply divides the cost by the number of years. Accelerated depreciation lets you deduct more of the cost earlier in the asset's life 2. This is clearly more advantageous for the company, and some argue it is the single biggest tax break for corporations. The Modified Accelerated Cost Recovery System is the standard method used for tax purposes in the United States.

Watch Out for EBITDA

EBITDA stands for earnings before interest, taxes, depreciation and amortization. Forbes has argued that it is a poor way to evaluate businesses because depreciation is not a cash outlay. You are looking in the rear-view mirror because the company has already spent the money and is just benefiting from the lingering depreciation years later. Remember, depreciation is a non-cash expense. The money has already been spent. It does not reflect cash flow except that it lowers taxes slightly.

Others, including the private equity industry, argue that EBITDA is a useful metric because it focuses on the core business, allows comparison across industries with varying levels of capital expenditure and provides a more accurate view of debt repayment ability as a cash flow proxy 3. Both sides have a point. The key is to understand what EBITDA excludes and not to treat it as a complete picture of financial health.

- 1Publication 946: How To Depreciate Property, IRS
- 2MACRS, Wikipedia
- 3Earnings Before Interest, Taxes, Depreciation and Amortization, Wikipedia

Summary

Depreciation is a non-cash expense that allocates the cost of a fixed asset over its useful life. Economic depreciation reflects value loss, while accounting depreciation follows IRS schedules. Expensing under $2,500 is immediate. Accelerated depreciation is the biggest corporate tax break. EBITDA can obscure reality.