Understanding depreciation and its importance for your business

Description

In accounting, depreciation is the systematic accounting for the reduction in the value of an asset. Depreciation is a very challenging concept to grasp, for both business and students because it is seemingly an abstract concept. The challenge stems from depreciation being a noncash-flow transaction, so while it appears as an expense in the books, no actual money is paid out.

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In this post, we look to explore why depreciating assets is so important if no amount is paid out for the depreciation expense. We will touch on how depreciating assets is a good financial management concept. We will not, however, be going into methods for calculating depreciation. Profit books wrote a good post on that here.

The Example

This post wishes to explore the practical applications of depreciation for businesses, particularly small businesses. To achieve this, we'll be relating back concepts to business with an example. So you can understand the real-life implications for business.

Say you want to start a business transporting school children to and from school. To achieve this you buy a mini-bus, at a cost of R50 000.00. You estimate the bus will have a useful life of five years after which you will have to replace it.

The business makes revenue of R10 000.00 per year for those five years. For the purposes of simplicity, let's say the only expenses incurred are fuel expenses of R10 000.00 per year. Given this, you are setting depreciation at R10 000.00 per year (R50 000.00/5), the value of the asset divided by its useful life.

Given this data, we can establish three key values in depreciating the mini-bus, being;

1. You reflect the market value of the asset

An asset you purchase today will have a greater value than the one from a year ago. This is because even with constant repair and maintenance, assets will suffer wear and tear. This also means the market value of the asset itself decreases. In our example, we could say the asset is worth half its original value at 2 years and 6 months (half its lifespan). If we are applying our depreciation, we would have depreciated the asset R25 000.00 and be carrying it at R25 000.00 on our balance sheet.

This ensures the asset is always carried at an amount you can rationally expect to get for it on the market. Depreciation, therefore, allows us to account for the wear and tear of an asset. This example uses what is called the straight-line method for accounting for depreciation so the value may not be immediately recognizable. There are however more practical methods.

You could, for example, using the reducing balance method to account for the accelerated depreciation an asset would suffer at the onset of its use. You could take it a step further and use analytics to analyze the exact wear on your asset for a period and account for the exact depreciation, but this could be overkill. The goal is to reflect that using the asset in that period has adversely affected its value and reflect it accordingly.

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Should the need arise for you to liquidate your asset for any reason, you know the exact amount you can expect for it. By accounting for wear and tear you also carry a more accurate value of your business on the balance sheet.

2. You match the cost of the asset to the revenue it generates

In accounting, the cost of an asset is recorded on the balance sheet and not the income statement. But the asset was purchased for the purpose of generating revenue. So its cost should be matched against the revenue it generates according to the matching concept. This is exactly what depreciating an asset allows you to do. It spreads the cost of an asset over its useful life.

In our example, without depreciation, the business breaks even over the five years. You make just as much revenue as you incur in expenses so other than your wasted time, the business was not a bad venture. But you remember you spent R50 000.00 on a van you would have otherwise not purchased if it wasn't for the business. So intuitively you know you lost somehow but why is it not reflecting.

With depreciation, this loss becomes obvious. By accounting for depreciation, expenses go up to R20 000.00 per annum and R100 000.00 over the 5-year period, while revenue remains at R50 000.00, meaning the loss for the period is R50 000.00. Including the depreciation expense allowed you to

spread the cost of R50 000.00 over the lifespan of the asset. It also allowed you to match revenue with the cost incurred in generating it since the asset was losing that much of the value invested in it to generate revenue.

With depreciation accounted for, profits reported are more realistic. This also has important tax implications as well, because without depreciation a profitable business could be paying more for tax than it should. More importantly, you could unwittingly pay taxes while you are actually incurring losses.

3. You create a reserve to replace the asset after its useful life

Your business is a going concern, so should it be profitable, you want to make sure it keeps going. That would be difficult of course if worn assets are not replaced. Naturally, you need to ensure you have cash reserves to replace assets when they reach the end of their useful life. Because depreciation is a noncash-flow expense, it creates a natural reserve by reducing the amount drawn as profits from cash by the value of the asset lost. You, therefore, have an amount needed to replace the asset when it reaches the end of its life.

To illustrate this, we need to modify our example a little. Say revenue was double annually, making it R20 000. Without depreciation, you would calculate profit at R50 000.00 (revenue – the fuel expense). Should you withdraw this amount in total as profit, at the end of the five years, you would have no amount to replace the minibus.

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With depreciation, however, profit would be zero (revenue – fuel expense – depreciation expense), meaning no withdrawals will be made from your accounts. But because unlike the fuel expense, no cash was paid out for the depreciation expense, your cash reserves accumulate an amount equal to the depreciation expense in any given period. At the end of the five years, you have cash equal to the value of the asset, to either replace it or recoup the initial amount of R50 000.00 spent on the van when the business was started.

Depreciation, therefore, safeguards you from over-drawing cash resources as profit.

Conclusion

While seemingly an abstract concept, depreciation has practical value for your business. Familiarise yourself with the various methods available for its calculation, pick one that best represents your business and apply it. You will get a more practical set of accounts that paint the prevailing picture on the ground, pay the right tax obligation and have reserves to replace assets and keep your business as a going concern. Remember though depreciating for tax purposes differs from depreciating internally so apply the right method.

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