Chapter 2

What is Depreciation?

When a company buys a building or a piece of equipment, the cost is capitalized, or set up in an asset account. One of the principles of accounting is matching revenue with expense. If we own a building that is rented out as a store or office, then it is involved in the production of revenue. How do we match the cost of the building to the revenue? A common denomination among all fixed assets is that they last longer than one year, and therefore they participate in generating many years' revenue. That is where the concept of depreciation comes in - taking the cost of an asset and spreading it over the years that will benefit from having the asset.

There are a number of choices when it comes to computing depreciation. The method of choice depends on the asset you're depreciating and how quickly you expect its value to decline. For tax purposes, all fixed assets purchased after 1986 must be depreciated using special method called the Modified Accelerated Cost Recovery system or MACRS(pronounced makers). We will discuss this in later chapters.

Computing Depreciation
Book vs. IRS

There are two sets of depreciation rules:

- The Internal Revenue Service (IRS) rules, which must be used to compute depreciation for the tax return; and
- Rules under Generally Accepted Accounting Principles (GAAP), which must be used to compute depreciation for the financial statements. GAAP depreciation rules are required for the financial statements because they more closely match an asset's cost with the revenue that the asset helps earn over it's life. Many small companies that do not need audited financial statements use tax depreciation methods for both their tax return and their financial statements. Using only the tax depreciation to avoid a reconciliation that must be done every year with the IRS.

Why There Are Two Ways to Compute Depreciation Expense

A company that prepares financial statements for a third party, such as a bank (to obtain a loan) for potential investors, or for a company that may want to acquire it, must use GAAP rules rather than IRS rules to compute depreciation. All publicly traded companies must use GAAP for their financial statements, which are filed with the Securities and Exchange Commission (SEC) and other government agencies. Companies that use GAAP must compute depreciation twice:

- Once under GAAP for their financial statements.
- Once under IRS rules for their federal tax return. The computation for the tax return is not recorded on the books. Furthermore, it must be reconciled with the IRS every year.