



DEPRECIATION: THE REAL COST

Few will dispute that depreciation is not a real cost, even though you do not write a check for it every year.

We view depreciation two different ways. The first is depreciation for tax purposes. Standards are set by the IRS to allow the amount of depreciation one is allowed to deduct as an expense.

The other economic depreciation – the actual cost of replacing equipment worn out in the production process. That is generally different than tax depreciation and as with the Section 179 allowances of recent years, tax depreciation often exceeds economic depreciation. I will concentrate on economic depreciation here.

IN THE PAST we figured machinery costs for different operations to benchmark costs as machinery cost per acre is one of the four most significant leverage points to maximizing profitability. In our client base we see machinery cost per acre vary by over \$160/acre.

In calculating machinery cost per

acre we traditionally used 25% of market value annually, 10% for depreciation, 10% interest or opportunity cost and 5% repairs.

This summer a client and I did a special study that sheds a different light on depreciation.

Often clients ask me to not take 10% depreciation, as their 4020 John Deere purchased in 1965 is worth more today than the original purchase price. Good point. However, if one looks at the definition of depreciation as the cost of replacing equipment, one needs to look at what it costs to replace a similar tractor (85 hp) today, and that is far greater.

BUT THE POINT is well taken, which lead me to calculate depreciation three different ways. We used a 225-hp tractor, an eight-row combine – each owned for 10 years – a 16-row planter owned for six years and a 90-ft. sprayer owned for four years. The planter went from a 16-row to 24 rows which significantly increased cost, but that is often what we do.

We calculated depreciation three ways. Looking at the chart, if one used the equipment and had a farm sale, depreciation is in the first column. If we replaced the equipment with the same horsepower and/or size, it's in the second column.

However, what really happens is we upgrade equipment with larger and more technologically advanced features. That is in the third column. As you can see it makes a significant difference.

Since the third column is what you have to pay for and following the definition that depreciation is the allocation of funds to replace equipment, then your real costs average 17.6% – much greater than the 10% we've traditionally used. **CSD**

DEPRECIATION VS. LEASING

A number of our clients are leasing combines. The depreciation saved on an annual basis more than pays for the lease cost of the base unit and there are no additional interest or opportunity costs on invested capital, no repairs, no storage and fewer insurance costs. I think this will be an increasing trend as it is riskwise. ◀

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DEPRECIATION CALCULATION SUMMARY			
ITEM	SELL	REPLACE	UPGRADE
TRACTOR	3.0%	9.5%	14.2%
COMBINE	4.4%	8.8%	13.8%
PLANTER	3.1%	1.3%	23.4%
SPRAYER	9.3%	14.0%	18.8%
AVERAGE	5.0%	8.4%	17.6%