

CHAPTER 7 TOPIC 2
ADJUSTING DEPRECIATION EXPENSE

Why do businesses acquire fixed assets such as building, various types of equipment, machinery, delivery truck etc?

- to carry on business

What is meant by the phrase "to carry on business"?

- the chief purpose of any business operation is to make money
- this is accomplished by producing revenue in excess of expenses incurred in a particular accounting period

A very important accounting principle

Fixed Assets, such as buildings, machinery, and delivery trucks, are acquired to produce revenue or to support revenue making activities.



Think of fixed assets as providing services to the business over a period of years.

Example

Acquiring a building is like a payment in advance for several years - "supply of housing"

- "houses" sales personnel who sell the service
- "houses" equipment & office personnel to support the operation of the business
- "houses" the customers who come to the business location

The building is acquired to **support revenue making activities** for a number of years to come. It is not acquired for the purpose of **resale**. If it were, it would cease to operate the moment the building were sold.

Example

A delivery truck which has been purchased offers transportation services to the business for a period of years or so many thousands of kilometres.

The purpose of acquiring the truck is to **support revenue making activities** of the business. It has not been acquired for resale

Remember, fixed assets have been acquired to **produce revenue or support revenue making activities for years to come** .

GAAP applied to reporting Fixed Assets on the balance sheet is the **cost principle**.

Accountants can only **estimate** how long a particular asset will assist in production of revenue making business.

Building - 10, 15, 20 years

Truck - 200,000 km - 5 years

The only thing we know for sure is the asset will not last forever.

Two factors that limit the useful life

Physical Deterioration - wear and tear resulting from use and climatic factors.

Obsolescence - the process of becoming out of date that occurs through technical innovation.

Example: Truck - exposed to sun, snow rain, wind
 - driven thousands of kilometres
 - variety of road conditions, in all types of weather
Building - older building / newer building
Computer -

Assets

2 important accounting concepts

1) fixed assets are acquired by business to produce revenue or support revenue-making activities

2) physical deterioration and obsolescence limit the length of time that fixed assets can generate revenue

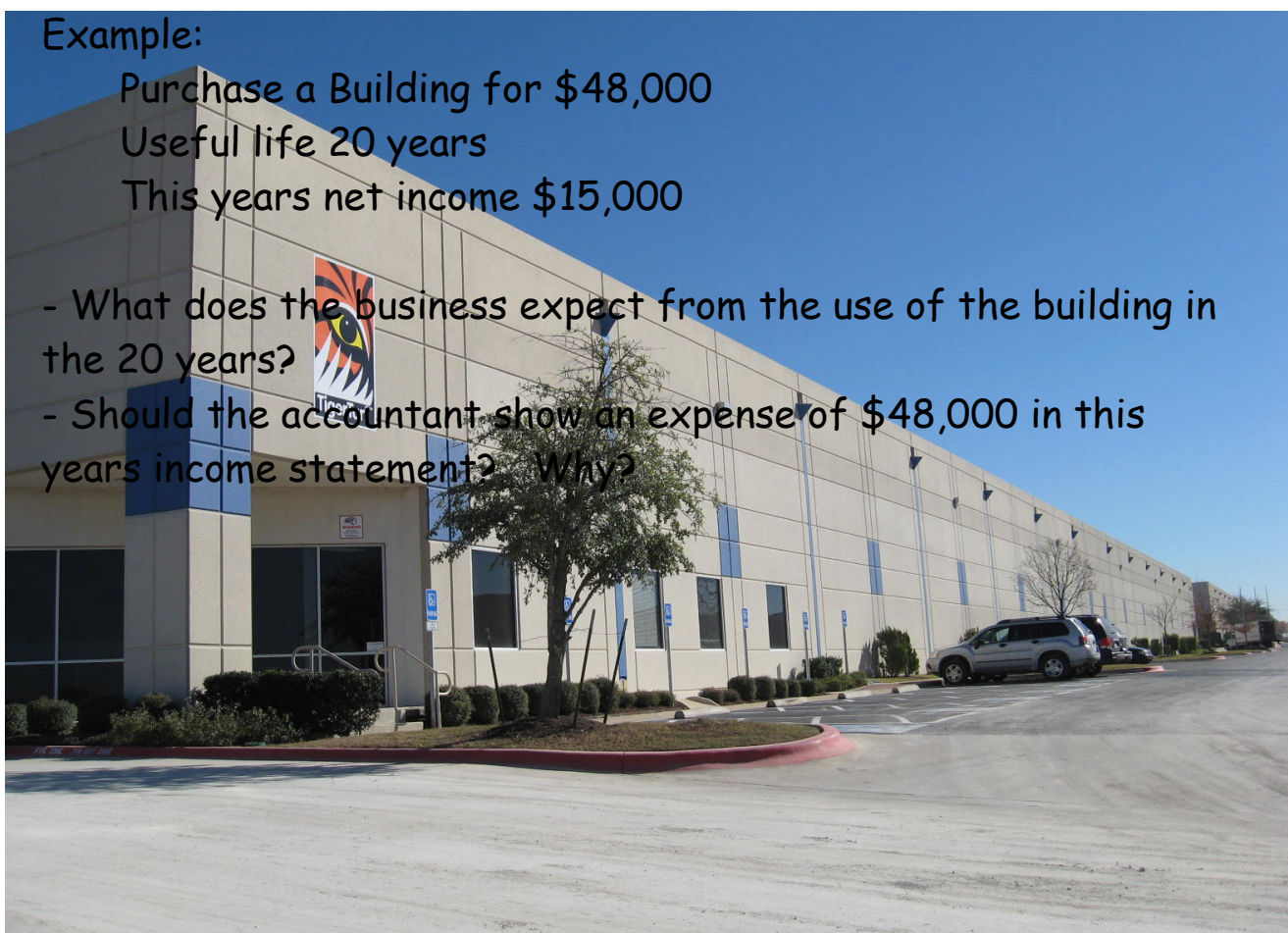
Example:

Purchase a Building for \$48,000

Useful life 20 years

This years net income \$15,000

- What does the business expect from the use of the building in the 20 years?
- Should the accountant show an expense of \$48,000 in this years income statement? Why?



DEPRECIATION ACCOUNTING

Diagram 1: Building costs at the beginning of the first year.
(The building has yet to be used.) **unexpired**

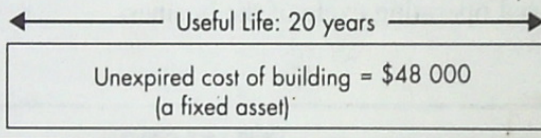
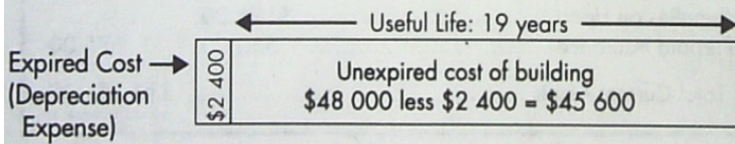
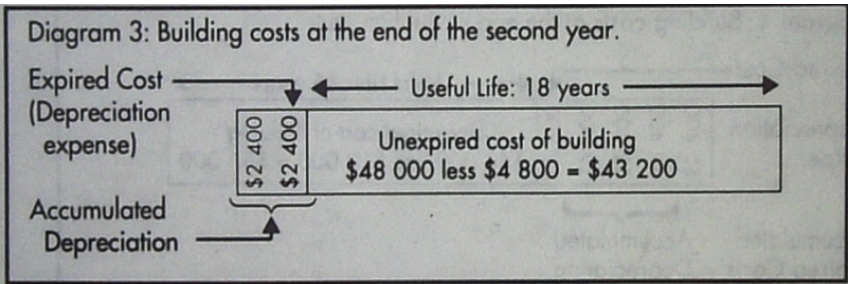


Diagram 2: Building costs at the end of the first year.



Spread the cost as evenly as possible over the useful life of the assets

Matching Principle
- produce revenue for 20 years, a fair portion of the cost must be matched for each of the 20 years.

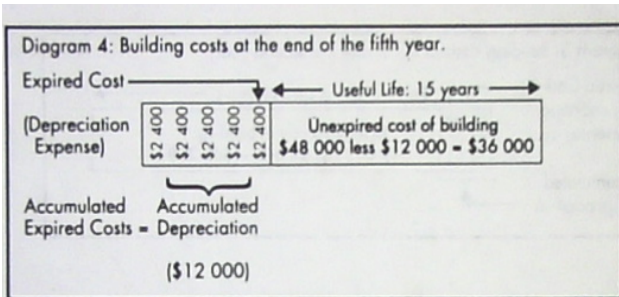


Depreciation Expense is the expired cost of using a fixed asset

original cost

Partial Balance Sheet (as at the end of the second year)	
Fixed Assets (at cost):	
Building	\$48 000
Less: Accumulated Depreciation	4 800
	<u>\$43 200</u>

Accumulated Depreciation is the total of the expired costs of any one asset



Depreciation is a process of allocating the cost of a fixed asset over its estimated useful life. It is not a process of evaluation.

Partial Income Statement
For the Year Ended December 31, 19-5

Operating Expenses:	
Depreciation Expense on Buildings	\$2 400

Partial Balance Sheet
as at December 31, 19-5

Fixed Assets (at cost):	
Building	\$48 000
Less: Accumulated Depreciation	<u>12 000</u>
	\$36 000

Depreciation is a process of allocating the cost of a fixed asset over its estimated useful life. It is not a process of evaluation.

There is one fixed assets that does not depreciate
???

Land - the cost of land must not be matched against the revenue of any accounting period.

2 Reasons

- 1) Land is acquired solely with the idea of serving as a useful site on which a depreciable building will be situated
- 2) Land is regarded as having unlimited life because its cost can be recovered once the building is, for example torn down.

Land is placed under Fixed Assets, at its original cost, there will be no accumulated depreciation. Never included with Buildings.

In the previous examples there was \$2400 of expired costs (depreciation expense) each year.

How do you record depreciation?

What will the debit entry be?

What will the credit entry be?

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DATE	ACCOUNT TITLE AND EXPLANATION	POST. REF.	DEBIT	CREDIT		
19-2						
Dec. 31	Depreciation Expense/Building Accumulated Depreciation/Building To record one year's depreciation on the building.	510 112	2 400 00		2 400 00	

Contra Account is an account that offsets another account.

Delta Real Estate Chart of Accounts	
EXPENSES	
510	Depreciation Expense/Building
511	Depreciation Expense/Warehouse Equipment
512	Depreciation Expense/Office Equipment
513	Depreciation Expense/Delivery Trucks

Delta Real Estate Chart of Accounts	
FIXED ASSETS	
110	Land
111	Building
112	Accumulated Depreciation/Building
113	Warehouse Equipment
114	Accumulated Depreciation/Warehouse Equipment
115	Office Equipment
116	Accumulated Depreciation/Office Equipment
117	Delivery Trucks
118	Accumulated Depreciation/Delivery Trucks

contra account

contra account

contra account

contra account

Cost Principle requires that a business always reports fixed assets at their original cost price

- only when accumulated depreciation is deducted from the original price can the expired cost of that fixed asset be accurately presented

- the accumulated depreciation account will not be closed at the end of the accounting period, because it represents the accumulation of depreciation expense

- every fixed assets account will have a related accumulated depreciation account with every fixed asset except LAND

Straight Line Depreciation - spreading out of depreciation in equal amounts over several periods.

- one of the most common methods to determine an amount of depreciation expense per year

$$\text{Straight Line Depreciation} = \frac{\text{Asset Cost} - \text{Disposal Value}}{\text{Estimated Life}}$$

Resale Value

Disposal Value: estimated value of the fixed asset when it is sold, scrapped, or traded (also referred to as a scrap value or salvage value)

January 1, 19-1 A cheque is issued for \$5200 to purchase furniture for an office.

Furniture		140	Accumulated Depreciation/ Furniture		141	Cash		101
19-1	Jan. 1	5 200				19-1	Jan. 1	5 200

December 31, 19-1 An adjustment entry is made to record the dollar amount of using the furniture for one year. Management has estimated a useful life of ten years and a disposal value of \$200 for this office furniture.

Furniture		140	Accumulated Depreciation/ Furniture		141	Depreciation Expense/ Furniture		526
19-1	Jan. 1	5 200	19-1	Dec. 31	500	19-1	Dec. 31	500

Straight Line Depreciation
 = $\frac{\text{Asset Cost} - \text{Disposal Value}}{\text{Estimated Life}}$

$$= \frac{5200 - 200}{10}$$

= 500 per year
 How could you calculate depreciation by month?

December 31, 19-1 An adjustment entry is made to record the dollar amount of using the furniture for one year. Management has estimated a useful life of ten years and a disposal value of \$200 for this office furniture.

Furniture		140	Accumulated Depreciation/Furniture		141	Depreciation Expense/Furniture		526
19-1	Jan. 1	5 200	19-1	Dec. 31	500	19-1	Dec. 31	500

Book Value: original asset cost less accumulated depreciation

$$\text{Book Value} = 5200 - 500$$

$$\text{Book Value} = 4700$$