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**Obsolescence** - the process of becoming out of date that occurs through technical innovation.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

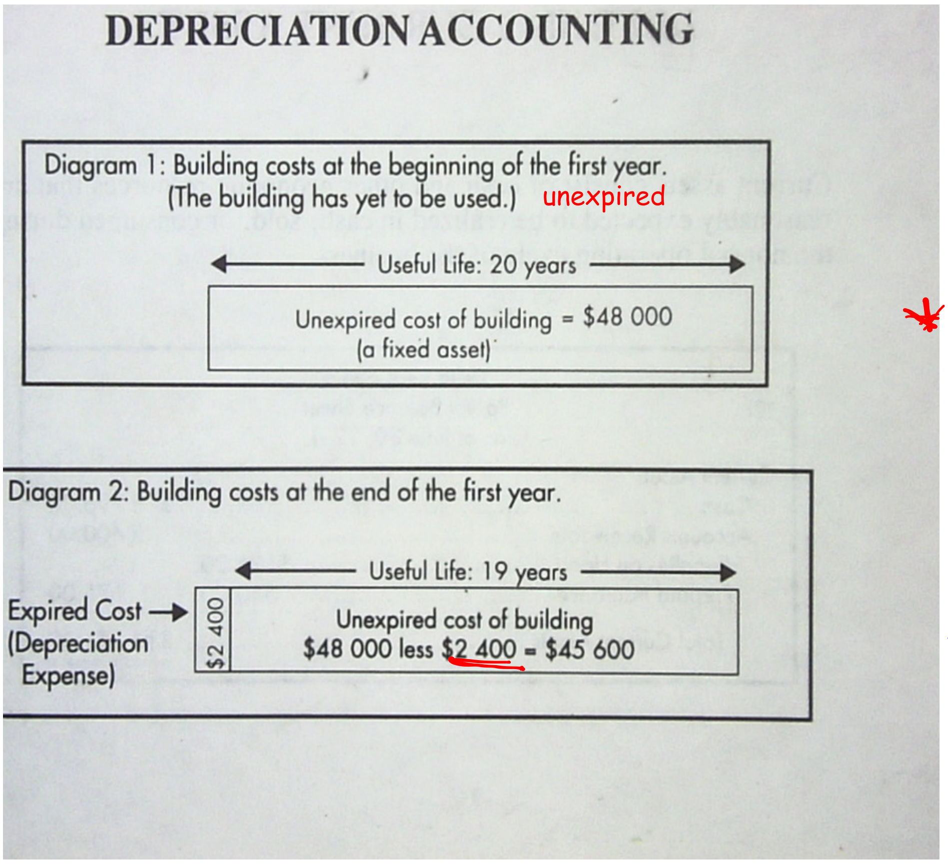
## Assets

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

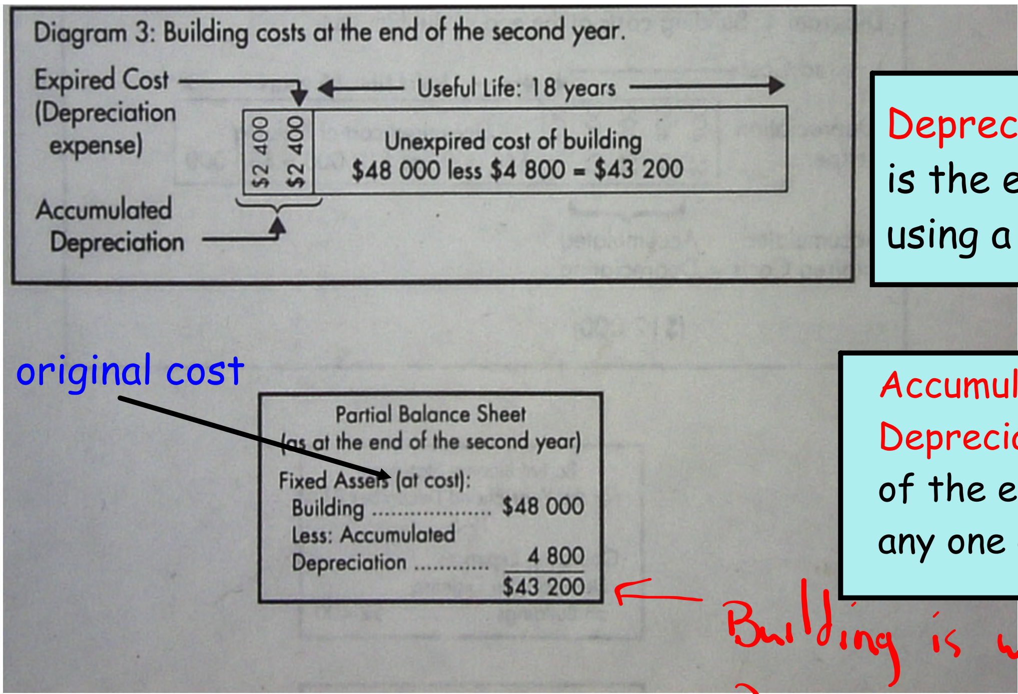

Example:
Purchase a Building for $48,000
Useful life 20 years
This years net income $15,000
- What does the business expect from the use of the building in the 20 years?
- Should the accountant show an expense of $48,000 in this years income statement? Why?




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.

$48000 \div 20 = \$2400$



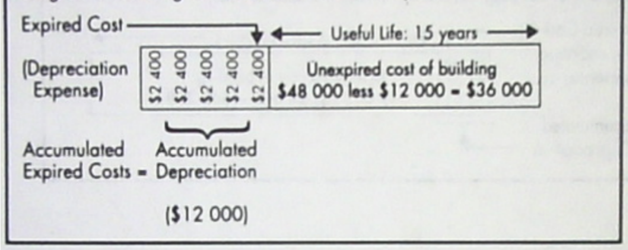

**Depreciation Expense** is the expired cost of using a fixed asset

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

original cost

Building is worth after 2 years.

Diagram 4: Building costs at the end of the fifth year.




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 | 12 000 |
| | $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.

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

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

Land - the cost of land <u>must not</u> 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? Depreciation Expense

What will the credit entry be? Accumulated Depreciation

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

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 contra account
113 Warehouse Equipment
114 Accumulated Depreciation/Warehouse Equipment contra account
115 Office Equipment
116 Accumulated Depreciation/Office Equipment contra account
117 Delivery Trucks
118 Accumulated Depreciation/Delivery Trucks contra account

Contra Account is an account that offsets another 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

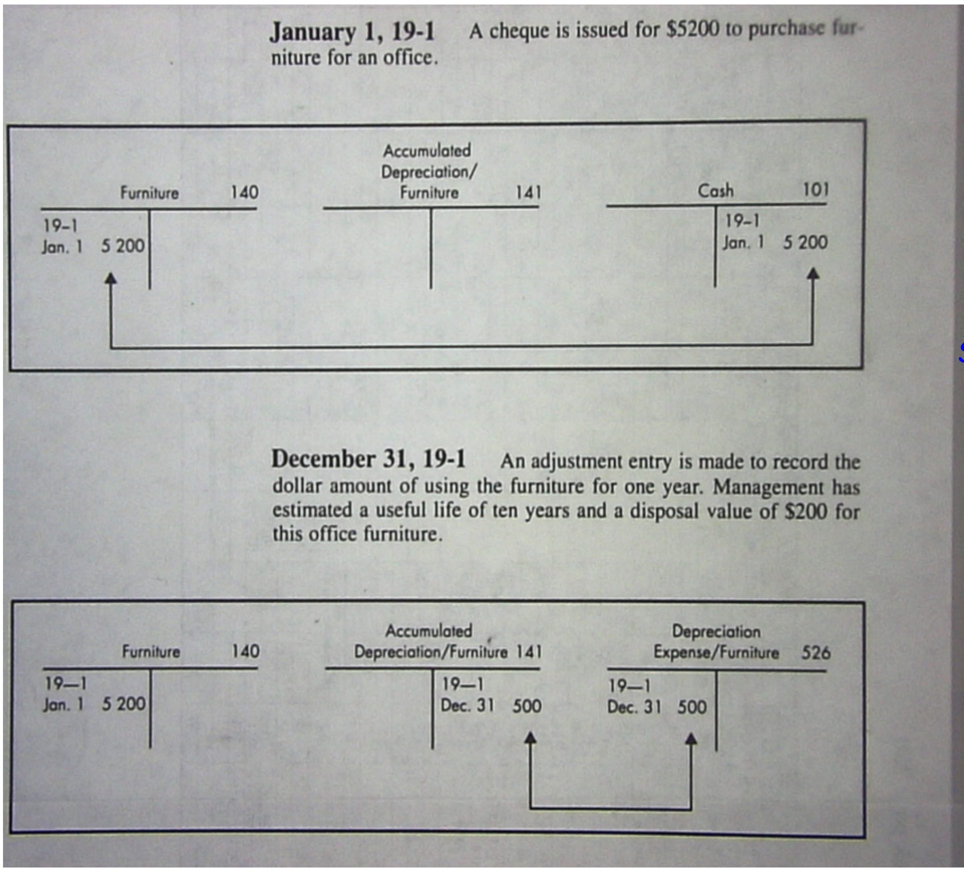
Straight Line Depreciation - spreading out of depreciation in equal amounts over several periods.

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

amount you could sell it for

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

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.



**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.



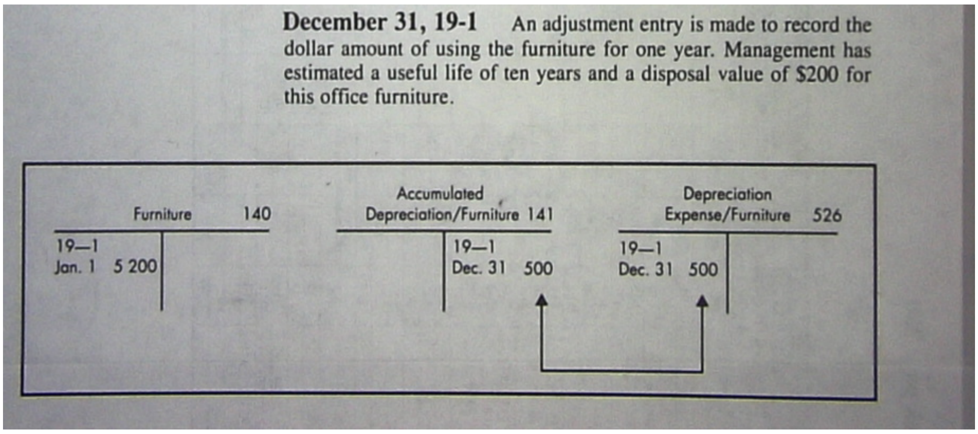
Straight Line Depreciation

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

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

= 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

Book Value = 5200 - 500
Book Value = 4700

7-4

| | Year | Asset Cost | Annual Depreciation | Acc. Depreciation |
|---|---|---|---|---|
| (1) | 19-4 | 83 000 | $\frac{83000-3000}{25} = 3200$ | 3200 |

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| | | | |
|---|---|---|---|
| 19-4 | Depreciation Expense/Building | 3200 | |
| | Accumulated Depreciation/Building | | 3200 |
| | To adjust for 1 year of depreciation | | |