

Planning and Recording Depreciation Adjustments

Categories of Assets: Most businesses use two broad categories of assets in their operations. Cash and other assets expected to be exchanged for cash or consumed within a year are called **current assets**. Assets that will be used for a number of years in the operation of a business are called **plant assets** (also known as long-term assets). Typical examples of plant assets might include computers, cash registers, display cases, and furniture. Businesses may have three major types of plant assets – equipment, buildings, and land.

Depreciating Plant Assets: A business buys plant assets to use in earning revenue. In order to match revenue with the expenses used to earn the revenue, the cost of a plant asset should be expensed over the plant asset's useful life. A portion of a plant asset's cost is transferred to an expense account in each fiscal period that a plant asset is used to earn revenue. The portion of a plant asset's cost that is transferred to an expense account in each fiscal period during a plant asset's useful life is called **depreciation expense**.

Three factors are considered in calculating the annual amount of depreciation expense for a plant asset:

1. **Original Cost.** The original cost of a plant asset includes all costs paid to make the asset usable to a business. These costs include the price of the asset, delivery costs, and any necessary installation costs.
2. **Estimated Salvage Value.** Generally, a business removes a plant asset from use and disposes of it when the asset is no longer usable. The amount that will be received for an asset at the time of its disposal is not known when the asset is bought. This, the amount that may be received at disposal must be estimated. The amount an owner expects to receive when a plant asset is removed from use is called **estimated salvage value**. Estimated salvage value may also be referred to as residual value or scrap value.
3. **Estimated Useful Life.** The total amount of depreciation expense is distributed over the estimated useful life of a plant asset. When a plant asset is bought, the exact length of useful life is not known. Therefore, the number of years of useful life must be estimated. Two factors affect the useful life of a plant asset: (1) physical depreciation and (2) functional depreciation. Physical depreciation is caused by wear from use and deterioration from aging and weathering. Functional depreciation occurs when a plant asset becomes inadequate or obsolete. An asset is inadequate when it can no longer satisfactorily perform the needed service. An asset is obsolete when a newer asset can operate more efficiently or produce better service.

Straight-Line Depreciation

Charging an equal amount of depreciation expense for a plant asset in each year of useful life is called the **straight-line method of depreciation**.

Example: Hobby Shack. On January 2, 2017, Hobby Shack purchased a lighted display case for \$1,250.00, with an estimated salvage value of \$250.00 and an estimated useful life of 5 years. Using the straight-line method of depreciation, the annual depreciation expense, \$200.00, is the same for each year in which the asset is used.

$$\begin{array}{rcl} \text{Original Cost} & - & \text{Estimated Salvage Value} & = & \text{Estimated Total Depreciation Expense} \\ \$1,250.00 & - & \$250.00 & = & \$1,000.00 \end{array}$$

$$\begin{array}{rcl} \text{Estimated Total Depreciation Expense} & \div & \text{Years of Useful Life} & = & \text{Annual Depreciation Expense} \\ \$1,000.00 & \div & 5 & = & \$200.00 \end{array}$$

Calculating Accumulated Depreciation

The total amount of depreciation expense that has been recorded since the purchase of a plant asset is called **accumulated depreciation**. The amount accumulates each year of the plant asset's useful life. First, the depreciation expense that has accumulated over all prior years is determined. Second, the depreciation expense for the current year is calculated. Third, the prior accumulated depreciation and current depreciation expense are added.

$$\begin{array}{rcl} \text{2016 Accumulated Depreciation} & + & \text{2017 Depreciation Expense} & = & \text{2017 Accumulated Depreciation} \\ \$400.00 & + & \$200.00 & = & \$600.00 \end{array}$$

Calculating Book Value

The original cost of a plant asset minus accumulated depreciation is called the **book value of a plant asset**. The book value is calculated by subtracting the accumulated depreciation from the original cost of the asset.

Example: Hobby Shack.

TRIAL BALANCE

ACCOUNT TITLE	UNADJUSTED					Adjustments					ADJUSTED														
	Debit		Credit			Debit		Credit			Debit		Credit												
<i>Office Equipment</i>	35	8	6	4	50											35	8	6	4	50					
<i>Acc. Depr. - Office Equipment</i>						6	4	9	7	00						6	5	4	0	00					
<i>Store Equipment</i>	40	8	4	9	50											40	8	4	9	50					
<i>Acc. Depr. - Store Equipment</i>						5	0	6	9	00						5	2	5	0	00					
<i>Depr. Exp. - Office Equipment</i>											6	5	4	0	00						6	5	4	0	00
<i>Depr. Exp. - Store Equipment</i>											5	2	5	0	00						5	2	5	0	00

GENERAL JOURNAL

2017 Date		Account Title	Doc. No.	Post. Ref.	Debit					Credit				
December	31	<i>Depr. Exp. - Office Equipment</i>			6	5	4	0	00					
		<i>Acc. Depr. - Office Equipment</i>								6	5	4	0	00
	31	<i>Depr. Exp. - Store Equipment</i>			5	2	5	0	00					
		<i>Acc. Depr. - Store Equipment</i>								5	2	5	0	00

Practice Problem 1: Calculating Depreciation Expense and Book Value

1. Calculate depreciation expense for a computer printer costing \$1,600.00; estimated salvage value, \$100.00; useful life, 5 years.
2. Calculate book value of the computer printer at the end of its second year of service.

Practice Problem 2: Calculating Depreciation Expense and Book Value

1. Calculate depreciation expense for a display rack costing \$2,350.00; estimated salvage value, \$600.00; useful life, 7 years.
2. Calculate book value of the display rack at the end of its third year of service.

Practice Problem 3: Calculating Depreciation Expense and Book Value

1. Calculate depreciation expense for a vehicle costing \$32,550.00; estimated salvage value, \$2,550.00; useful life, 10 years.
2. Calculate book value of the vehicle at the end of its fifth year of service.

