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Plant assets are depreciated because

Depreciation is defined as the expensing of the cost of an asset involved in producing revenues throughout its useful life. Summarize the purpose of depreciating an asset Key Takeaways Key Points Depreciation expense reduces the book value of an asset and reduces an accounting period's earnings. The expense is recognized throughout an asset's useful life. The calculation of depreciation expense follows the matching principle, which requires that revenues earned in an accounting period be matched with related expenses. Depreciation expense can be calculated in a variety of ways; the method chosen should be appropriate to the asset type, the asset's expected business use, and its estimated useful life. Key Terms residual value: In accounting, residual value is another name for salvage value, the remaining value of an asset after it has been fully depreciated. accrual accounting: refers to the concept of recognizing and reporting revenues when earned and expenses when incurred, regardless of the effect on cash. Depreciation is defined as the expensing of an asset involved in producing revenues throughout its useful life. Depreciation for accounting purposes refers the allocation of the cost of assets to periods in which the assets are used (depreciation with the matching of revenues to expenses principle). Depreciation expense affects the values of businesses and entities because the accumulated depreciation disclosed for each asset will reduce its book value on the balance sheet. Depreciation expense also affects net income. Generally the cost is allocated as depreciation expense among the periods in which the asset is expected to be used. Such expense is recognized by businesses for financial reporting and tax purposes. Depreciation reflects the wear and tear experienced by an asset in use.: Cars depreciate in value throughout their useful life. Depreciation and the Matching Principle Depreciation expense reduces an accounting period's income even though the expense does not require a cash or credit payment. The reason for the expense is to comply with the matching principle required by accrual accounting. According to the principle, expenses are recognized regardless of cash payment when obligations are: incurred (usually when goods are transferred (sold) or services rendered), generated by expenses involved in the earning of the accounting period's revenues. Depreciation Expense Calculation Depreciation expense can be calculated using a variety of methods. The depreciation method chosen should be appropriate to the asset type, its expected business use, its estimated useful life, and the asset's residual value. The expense is recognized and reported when the asset is placed into use and is calculated for each accounting period and reported under Accumulated Depreciation on the balance sheet and Depreciation Expense on the income statement. The amount reduces both the asset's value and the accounting period's income. A depreciation method commonly used to calculate depreciation expense is the straight line method. There are four main factors that affect the calculation of depreciation expense: asset cost, salvage value, useful life, and obsolescence. Summarize how a company would determine the appropriate depreciation method to use Key Takeaways Key Points A company is free to adopt the most appropriate depreciation method for its business operations. Companies can choose a method that allocates asset cost to accounting periods according to benefits received from the use of the asset. The depreciation method used should allocate asset cost to accounting periods in a systematic and rational manner. Key Terms obsolescence: The process of becoming obsolete, outmoded, or out of date. There are four main factors to consider when calculating depreciation expense: The cost of the asset The estimated salvage value of the asset. Salvage value (or residual value) is the amount of money the company expects to recover, less disposal costs, on the date the asset is scrapped, sold, or traded in. Estimated useful life of the asset. Useful life refers to the window of time that a company plans to use an asset. Useful life can be expressed in years, months, working hours, or units produced. Obsolescence should be considered when determining an asset's useful life and will affect the calculation of depreciation. For example, a machine capable of producing units for 20 years may be obsolete in six years; therefore, the asset's useful life is six years. Factors Affecting the Depreciation Method A company is free to adopt the most appropriate depreciation method for its business operations. Accounting theory suggests that companies use a depreciation method that closely reflects the operations' economic circumstances. So, companies can choose a method that allocates asset cost to accounting periods according to benefits received from the use of the asset. Most companies use the straight-line method for financial reporting purposes, but they may also use different methods for different assets. The most important criteria to follow: Use a depreciation method that allocates asset cost to accounting periods in a systematic and rational manner. Types of Depreciation Methods The following four methods allocate asset cost in a systematic and rational manner: straight line, units of production, sum-of-years-digits, and double-declining balance. Examples of Depreciation Expense Calculations Here is an example of how to calculate depreciation expense under the straight-line method. Assume a purchased truck is valued at \$10,000, has a residual value of \$5,000, and a useful life of 5 years. Its depreciation expense for year 1 is
$$\frac{\$10,000 - \$5,000}{5} = \$1,000$$
 The journal entry for this transaction is a debit to Depreciation Expense for \$1,000 and a credit to Accumulated Depreciation for \$1,000. The depreciation expense is reported on the income statement as a reduction to revenues and accumulated depreciation is reported as a contra account to its related Delivery Truck asset account (reduces the asset's cost to its book value) on the balance sheet. Here is an example of how to calculate depreciation expense under the units of production method. Assume a piece of machinery, purchased for \$100,000 with a residual value of \$40,000, is expected to produce 10,000 units over its useful life. First, calculate the depreciation per unit:
$$\frac{\$100,000 - \$40,000}{10,000} = \$6$$
 The depreciation expense for the period is the per unit amount multiplied by the period's production amount: if 1,000 units were produced, the depreciation expense is
$$1,000 \cdot \$6 = \$6,000$$
 This amount is disclosed on the income statement and is part of the asset's accumulated depreciation on the balance sheet. Here is an example of how to calculate depreciation expense under the sum-of-years-digits. Assume a piece of machinery is purchased for USD 100,000 with a residual value of \$40,000 and a useful life of 5 years. First, calculate the depreciation rate by adding the years of useful life, or
$$1 + 2 + 3 + 4 + 5 = 15$$
 Second, calculate the depreciation rate by adding the years of useful life, or
$$\frac{\$100,000 - \$40,000}{15} = \$20,000$$
 For year 4, the calculation uses the asset's book value
$$(\$100,000 - \$20,000)$$
 subtracted by its residual value
$$(\$40,000)$$
 and multiplied by the rate for year 4
$$\left(\frac{4}{15}\right)$$
 To calculate depreciation using the double-declining method, its possible to double the amount of depreciation expense under the straight-line method. To do this, divide 100 per cent by the number of years of useful life of the asset. Then, multiply this rate by 2. Next, apply the resulting double-declining rate to the declining book value of the asset (cost subtracted by accumulated depreciation). Ignore salvage value in making the calculations. At the point where book value is equal to the salvage value, no more depreciation is taken. There are various methods that can calculate depreciation expense for the period; the method used should reflect the asset's business use. Differentiate between the straight-line, units of production, sum of the years digits and double declining methods of calculating depreciation Key Takeaways Key Points Straight-line depreciation is the simplest and most popular method; it charges an equal amount of depreciation to each accounting period. The units-of-production depreciation method assigns an equal amount of expense to each unit produced or service rendered by the asset. The sum-of-the-years-digits method determines annual depreciation by multiplying the asset's depreciable cost by a series of fractions based on the sum of the asset's useful life digits. The double-declining balance is a type of accelerated depreciation method that calculates a higher depreciation charge in the first year of an asset's life and gradually decreases depreciation expense in subsequent years. Key Terms historical cost: The original monetary value of an economic item and based on the stable measuring unit assumption. Improvements may be added to an asset's cost. useful life: the length of time, typically in years, that an asset is expected to function and be useful. salvage value: also known as residual value; the remaining value of an asset after it has been fully depreciated. Some of the most common methods used to calculate depreciation are straight-line, units-of-production, sum-of-years digits, and double-declining balance, an accelerated depreciation method. The Modified Accelerated Cost Recovery System (MACRS) is the current tax depreciation system used in the United States. There are several asset depreciation methods to choose from.: The depreciation method for an automobile should reflect the asset's use throughout its life. Straight-Line Straight-line depreciation has been the most widely used depreciation method in the U.S. for many years due to its simplicity. To apply the straight-line method, a company charges an equal amount of the asset's cost to each accounting period. The straight-line formula used to calculate depreciation expense is: (asset's historical cost - the asset's estimated salvage value) / the asset's useful life. An example of how to calculate depreciation expense under the straight-line method — assume a purchased truck is valued at USD 10,000, has a residual value of USD 5,000, and a useful life of 5 years. Its depreciation expense for year 1 is USD 1,000
$$\frac{10,000 - 5,000}{5}$$
 The journal entry for this transaction is a debit to Depreciation Expense for USD 1,000 and a credit to Accumulated Depreciation for USD 1,000. The depreciation expense is reported on the income statement as a reduction to revenues and accumulated depreciation is reported as a contra account to its related Delivery Truck asset account (reduces the asset's cost to its book value). Units of Production The units-of-production depreciation method assigns an equal amount of expense to each unit produced or service rendered by the asset. This method is typically applied to assets used in the production line. The formula to calculate depreciation expense involves two steps: (1) determine depreciation per unit (asset's historical cost - estimated salvage value) / estimated total units of production during the asset's useful life); (2) determine the expense for the accounting period (depreciation per unit X number of units produced in the period). An example of how to calculate depreciation expense under the units of production — assume a piece of machinery, purchased for USD 100,000 with a residual value of 40,000, is expected to produce 10,000 units over its useful life. First, calculate the depreciation per unit —
$$\frac{100,000 - 40,000}{10,000}$$
 or USD 6 per unit. The depreciation expense for the period is the per unit amount multiplied by the period's production amount — if 1,000 units were produced, depreciation expense equals USD 6,000
$$1,000 * 6$$
. This amount is disclosed on the income statement and is part of the asset's accumulated depreciation on the balance sheet. Sum-of-years-digits Sum-of-years-digits is a depreciation method that results in a more accelerated write-off than straight line, but less accelerated than that of the double-declining balance method. Under this method, annual depreciation is determined by multiplying the depreciable cost by a series of fractions based on the sum of the asset's useful life digits. The sum of the digits can be determined by using the formula
$$n(n+1)/2$$
, where n is equal to the useful life of the asset. To calculate depreciation expense under the sum-of-years-digits — assume a piece of machinery is purchased for USD 100,000 with a residual value of 40,000 and a useful life of 5 years. First, calculate the depreciation rate by adding the years of useful life, or
$$1 + 2 + 3 + 4 + 5$$
 (equal to 15). Second, calculate the depreciation expense for year 5 —
$$100,000 - 40,000 * 5/15$$
, or USD 20,000. For year 4, the calculation uses the asset's book value
$$100,000 - 20,000$$
 subtracted by its residual value
$$40,000$$
 and multiplied by the rate for year 4
$$4/15$$
. Double-declining Balance The double-declining balance method is a type of accelerated depreciation method that calculates a higher depreciation charge in the first year of an asset's life and gradually decreases depreciation expense in subsequent years. To calculate depreciation expense, use double the straight-line rate. For example, suppose a business has an asset with a cost of 1,000, 100 salvage value, and 5 years useful life. First, calculate the straight-line depreciation rate. Since the asset has 5 years useful life, the straight-line depreciation rate equals
$$100\% / 5$$
 or 20% per year. With double-declining-balance, double that rate to arrive at 40%. Apply the rate to the book value of the asset (cost subtracted by accumulated depreciation) and ignore salvage value. At the point where book value is equal to the salvage value, no more depreciation is taken. MACRS Under MACRS, the capitalized cost (basis) of tangible property is recovered by annual deductions for depreciation over a specified life. The lives are specified in the Internal Revenue Service's (IRS) Tax Co de. The IRS publishes detailed tables of asset lives by asset class. The deduction for depreciation is computed under one of two methods (declining balance switched to straight line or only straight line) at the election of the taxpayer. Certain limitations may apply. The choice of depreciation method can impact revenues on the income statement and assets on the balance sheet. Explain how the choice of depreciation method affects a company's revenue Key Takeaways Key Points These four methods of depreciation (straight line, units of production, sum-of-years-digits, and double-declining balance) impact revenues and assets in different ways. The effect of the straight-line method is a stable and uniform reduction in revenues and asset values in every accounting period of the asset's useful life. Depreciation expense under units-of-production, based on units produced in the period, will be lower or higher and have a greater or lesser effect on revenues and assets. Sum-of-years digits is a depreciation method that results in a more accelerated write off of the asset than straight line but less than declining-balance method. For the double-declining balance method, revenues and assets will be reduced more in the early years of an asset's life, due to the higher depreciation expense, and less in the later years. Key Terms declining-balance method: depreciation is based on a percent of the asset's previous year ending book value balance sheet. A summary of a person's or organization's assets, liabilities, and equity as of a specific date. income statement: A calculation which shows the profit or loss of an accounting unit (company, municipality, foundation, etc.) during a specific period of time, providing a summary of how the profit or loss is calculated from gross revenue and expenses. accelerated depreciation: Accelerated depreciation methods calculate a higher depreciation charge in the first year of an asset's life, with gradually decreasing charges in subsequent years. This may be a more realistic reflection of an asset's actual expected benefit based on the use of the asset; many assets are most useful when they are new. accelerated-depreciation method: a company, for financial accounting or tax purposes, depreciates a fixed asset in such a way that the amount of depreciation taken each year is higher during the earlier years of an asset's life Depreciation is a required expense for all business with fixed assets, excluding land. The choice of the depreciation method can impact revenues on the income statement and assets on the balance sheet. The four most common methods of depreciation that impact revenues and assets are: straight line, units of production, sum-of-years-digits, and double-declining balance. Different depreciation methods have different effects on revenues and assets.: The depreciation method used to depreciate a car calculates an expense that reduces income. Straight Line When using the straight-line method, a company charges the same depreciation expense every accounting period throughout an asset's useful life, so the effect is a stable and uniform reduction in revenues and asset values in every accounting period of the asset's useful life. Here is an example of how to calculate depreciation expense under the straight-line method. Assume a purchased truck is valued at \$10,000, has a residual value of \$5,000, and a useful life of 5 years. Its depreciation expense for year 1 is
$$\frac{\$10,000 - \$5,000}{5} = \$1,000$$
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 This amount is disclosed on the income statement and is part of the asset's accumulated depreciation on the balance sheet. Sum-Of-Years-Digits Sum-of-years-digits depreciation is determined by multiplying the asset's depreciable cost by a series of fractions based on the sum of the asset's useful life digits. Sum-of-years digits is a depreciation method that results in a more accelerated write off of the asset than straight line but less than double-declining balance method. This method will reduce revenues and assets more rapidly than the straight-line method but not as rapidly as the double-declining method. Here is an example of how to calculate depreciation expense under the sum-of-years-digits. Assume a piece of machinery is purchased for USD 100,000 with a residual value of \$40,000 and a useful life of 5 years. First, calculate the depreciation rate by adding the years of useful life, or
$$1 + 2 + 3 + 4 + 5 = 15$$
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$$\frac{\$100,000 - \$40,000}{15} = \$20,000$$
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$$(\$100,000 - \$20,000)$$
 subtracted by its residual value
$$(\$40,000)$$
 and multiplied by the rate for year 4
$$\left(\frac{4}{15}\right)$$
 Double-Declining Balance Double-declining balance is a type of accelerated depreciation method. This method records higher amounts of depreciation during the early years of an asset's life and lower amounts during the asset's later years. Thus, in the early years, revenues and assets will be reduced more due to the higher depreciation expense. In later years, a lower depreciation expense can have a minimal impact on revenues and assets. However, revenues may be impacted by higher costs related to asset maintenance and repairs. To calculate depreciation using the double-declining method, its possible to double the amount of depreciation expense under the straight-line method. To do this, divide 100 per cent by the number of years of useful life of the asset. Then, multiply this rate by 2. Next, apply the resulting double-declining rate to the declining book value of the asset (cost subtracted by accumulated depreciation). Ignore salvage value in making the calculations. At the point where book value is equal to the salvage value, no more depreciation is taken.

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