6.- RECORDING DEPRECIATION

Let us take a brief look at how to record depreciation. We have to debit an expense (*Depreciation Expense*) and credit *Accumulated Depreciation* (a contra-account to *Tangible Assets*). No matter which method is used to calculate depreciation, the journal entry to record it is as follows:

Depreciation Expense………………………………….. XXX
Accumulated Depreciation……………………...............XXX

Depreciation decreases the asset's book value (through *Accumulated Depreciation*) and also decreases the net income and equity (though *Depreciation Expense*). The *book value* of a tangible asset is equal to the *cost of the asset* minus its *accumulated depreciation*.

Example: If a van costs $24,000 and was expected to be used for 3 years, it can be estimated at the end of the first year that 1/3 of its useful life has been consumed. Let us assume that the depreciation charge is constant over the life of the van. The first year the company will charge $8,000 due to depreciation.

Depreciation Expense………………………………….. 8,000
Accumulated Depreciation………………………………….8,000

The net income would be reduced by $8,000 and the value of the van in the Balance Sheet (book value of the van) would be reduced from $24,000 to $16,000 (24,000-8,000).

DEPRECIATION AND THE STATEMENT OF CASH FLOWS

The statement of cash flows reports cash flows (cash receipts and cash payments) and describes where cash came from and how it was spent. Depreciation is an expense related to Operating Activities. As an expense, it reduces the Net Income. However, depreciation has no effect on cash. To convert Net Income to cash flows, we need to add depreciation back to net income (in Cash Flows from Operations). The add-back cancels the earlier deduction.

From the example above: Suppose the company had only two transactions: a) a $12,000 cash sale and b) the depreciation expense calculated above ($8,000).

Net Income: $12,000 - $8,000 = $4,000
Cash flows from operations = $12,000 (depreciation has no impact on cash)

To go from Net Income ($4,000) to cash flow ($12,000), we add back the depreciation ($8,000).

ACCOUNTING FOR DISPOSAL OF TANGIBLE ASSETS

Let us assume that a tangible asset, for some reason, ceases to be useful to an organization. Before accounting for the disposal of an asset, an organization should bring depreciation up to date to measure the book value of the asset and record the expense up to the date of sale. To account for disposal, we need to remove the asset and its related accumulated depreciation from the books. Let us consider two different scenarios:

a.- A fully depreciated asset. The entry to record the disposal of this asset will be:

Accumulated Depreciation Machinery……………..…… Y
Machinery…………………………………………….……Y

b.- **An asset not fully depreciated**. The entry to record the disposal will be:

Accumulated Depreciation Machinery………………..…. X
Loss on Disposal of Machinery………………………..…. Y-X
Machinery…………………………………………………..Y

ACCOUNTING FOR THE SALE OF TANGIBLE ASSETS

Let's now assume that an organization sells a tangible asset. Before recording the sale, the company must update the depreciation of the asset. If the price paid for the machine is higher than its book value, the company will have a gain. To record the sale we will proceed as follows:

Cash…………………………………………………..…. X
Accumulated Depreciation Machinery………………..…. Y
Machinery…………………………………………….Z
Gain on Sale of Machinery……………………………..(X+Y) – Z