

Chapter 3

Depreciation under GAAP (For book purposes)

Most plant and equipment assets wear out or become obsolete over the years. Similarly, although land is not depreciated (because it does not wear out), improvements to land, such as paving or fences, are depreciated because these improvements wear out or become obsolete over time. As described earlier, the portion of the asset “used up” (worn out) each year is depreciation expense, or simply depreciation. Depreciation for each asset is usually calculated separately and is based on four factors:

- a. The asset’s cost;
- b. The asset’s estimated life;
- c. The asset’s residual value (its book value after being fully depreciated); and
- d. The method of depreciation selected.

Determining the Asset’s Cost

As we said earlier, for depreciation purposes, the cost (historical cost, original cost or acquisition cost) is more than just the invoice price. It includes any cost incurred to acquire, transport and prepare the asset for its intended use, such as sales tax, commissions, title fees, transportation, and installation. (See page 3).

Determining the Asset’s Estimated Life

The estimated life is the number of years the company expects the asset to last or the amount of production it expects from the machine measured in hours, miles, units produced, or any other standard. For example, a machine’s life may be measured in years of expected use or units of expected production; an automobile in years or miles or hours of expected use; a building in years of expected use.

Determining the Asset’s Residual Value (or Scrap Value or Salvage Value)

The residual value is an estimate made by company management of the dollar amount that can be recovered for the asset at the end of its useful life when it is disposed of (sold or traded in). This amount cannot be depreciated. When the residual value is subtracted from the acquisition cost, the remainder is the full amount that can be depreciated and is referred to as the depreciable base.

$$\textit{Acquisition cost} - \textit{residual value} = \textit{depreciable base}$$

To put it another way, when total depreciation taken on an asset equals the depreciable base, the asset has been fully depreciated.