Chapter 11: Depreciation and Depletion

I. Depreciation
   A. Process of cost allocation -- We are trying to recognize the fact that, over time, an asset’s usefulness (service potential) declines. Therefore, the cost of the asset should be written off to expense as the asset is used to produce revenue – an application of the matching principle.
   B. Depreciation does not measure loss in value
   C. Three parameters needed
      1) Depreciable Base – amount to be depreciated (cost less salvage)
      2) Useful Life – this is the amount of time that we expect the asset will be productive
      3) Depreciation Pattern/Method - should be systematic and rational
   D. Depreciation Methods
      1) Activity Method -- Depreciation = f(use)
      2) Straight-line depreciation -- depreciation = f (time)
      3) Accelerated or Decreasing Charge Methods -- depreciation is a decreasing function of time. That is, more depreciation is charged in the early years and lower depreciation amounts are charged in the later years.
         (a) Sum of years digits (SYD):
         (b) Declining Balance Method
      4) Understand the graphical presentation of these methods
   E. Partial year depreciation.
      -- First, compute a full year of depreciation
      -- Next, prorate this year of depreciation expense between the 2 periods involved.
   F. Revision of Depreciation Rates – what do we do when we realize our depreciation estimates are incorrect? Revise the estimate in the current and future periods only - prospectively.

II. Depletion
   A. Depletion is the writing off of the cost of a natural resource over the period that the natural resource is physically consumed.
   B. Depletion is recorded using the activity approach of depreciation
   C. What makes up the depletion base?
      -- Acquisition cost - Include this in the depletion base
      -- Exploration cost: Generally, these are expensed but in some cases they are recorded as part of the cost of the asset (only when the exploration costs are substantial and the risks of finding the resource uncertain)
      -- Development costs:
         -- Tangible Equipment - depreciate
         -- Intangible Development Costs - include in depletion base
      -- Restoration Costs - include in depletion base
III. Asset Impairments

A. An impairment is a partial obsolescence -- that is, the CV of a fixed asset becomes unrecoverable -- we don’t wish to report an asset at an amount greater than what is recoverable.

B. Criterion for assessing probability of impairment – recoverability test
   1) Compare the sum of expected future undiscounted cash flows to the asset’s CV.
   2) If cash flows > CV, no impairment
      If cash flows < CV, impairment

C. Computing the loss
   1) Look at the difference between the CV and the fair value of the asset.
   2) Journal entry:
      Loss on Impairment xx
      Accum. Deprec. xx

D. Held for use asset
   1) Restoration of impairment loss prohibited

E. Intend to Sale asset
   1) Must consider disposal costs in computing the loss
   2) Any loss recognized can be restored up the CV prior to the impairment
   3) Also, notice that you do not have to take depreciation on the fixed asset