Financial Accounting

Part B: Capital or Operating

Recall from last lecture…

BitCo’s purchase of a screwdriver and a robot. Let us first consider the robot…

If we record the purchase as an **expense** for this year:

- we will likely have a big loss this year
- we will own a slightly used robot that we could sell, but it won’t show on our books at all
- profit in following years will be higher than it ‘should’ be, because we are getting ‘free’ use of the robot

Impact on statements

Let’s look at how **expensing** the robot impacts our Income Statement and our Balance Sheet

Capital Equipment

- Appears on Balance Sheet as an asset
- Appears on the Income Statement as Depreciation
- Anything from which you will gain benefit for more than a year.

Depreciation

- A way to “use up” a portion of a Capital Asset a little each year.
- Schemes:
  – straight line
  – declining balance
- Recorded in a depreciation schedule

Back to our robot

Assume the robot will last 10 years and be worth nothing at the end of it’s life.

➔straight line depreciation of 10% per year

Let’s look at:

- the depreciation schedule
- impact on balance sheet
- impact on income statement

Straight Line Depreciation (10%)

- With straight line depreciation an item is depreciated by the same absolute amount each year. This yearly amount is a percentage of the initial value.
- With straight line depreciation the book value of an item eventually goes to zero.

Now try declining balance

Each year the robot is worth 20% less

Let’s look at:

- the depreciation schedule
- impact on balance sheet
- impact on income statement

Declining Balance Depreciation (20%)

- When using declining balance depreciation, each year’s depreciation is a percentage of the opening book value for that year.
- Using a 20% depreciation rate, a $2000 item will depreciate $400 the first year and close the year with a book value of $1,600.
- In year two the item will start with a book value of $1600, depreciate $320, and close the year with a book value of $1,280.
- In year three the item will start with a book value of $1,280, depreciated $256, and close the year with a book value of $1,024.

Fine Print

- Generally only ½ years depreciation is allowed in the first year, no matter when the asset is purchased

Why do you think this is?

What about our screwdriver?

Will it last more than a year?

Is it ‘worth’ the work to maintain a depreciation schedule for a $2 item?