

Pharoah Company Purchased A New Machine On October 1, 2022, At A Cost Of \$91,360. The Company Estimated

Pharoah Company Purchased A New Machine On October 1, 2022, At A Cost Of \$91,360. The Company Estimated that this acquisition would significantly enhance its manufacturing capabilities and operational efficiency. As part of its strategic growth plan, Pharoah Company invested in a new piece of machinery to meet increasing demand and improve product quality. Understanding the accounting treatment, depreciation, and financial implications of this purchase is crucial for accurate financial reporting and compliance with accounting standards. This article provides a comprehensive overview of the acquisition, including the purchase details, depreciation methods, and key considerations for recording such a transaction.

Overview of the Machine Purchase

Details of the Acquisition

On October 1, 2022, Pharoah Company acquired a new manufacturing machine at a cost of \$91,360. The purchase included the purchase price, taxes, transportation costs, installation fees, and other directly attributable costs necessary to bring the asset to its intended use.

Significance of the Purchase

Investing in new machinery typically aims to:

- Increase production capacity
- Enhance product quality
- Reduce manufacturing costs
- Maintain competitive advantage

For accounting purposes, it is essential to accurately capitalize the asset and determine its depreciation over its useful life.

Accounting for the Purchase

Initial Recognition and Capitalization

According to generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS), the cost of acquiring a fixed asset includes all expenditures necessary to acquire the asset and prepare it for use. These include:

- Purchase price of \$91,360
- Transportation costs
- Installation and setup costs
- Testing costs prior to use

The total of these costs should be capitalized on the balance sheet as property, plant, and equipment (PP&E).

Recording the Asset

The journal entry to record the purchase on October 1, 2022, would be:

Debit: Machinery & Equipment – \$91,360
Credit: Cash / Accounts Payable – \$91,360

This entry reflects the acquisition of the machinery at its historical cost.

Depreciation of the Machinery

Understanding Depreciation

Depreciation allocates the cost of a tangible fixed asset over its useful life. It recognizes the wear and tear, obsolescence, or decline in value as the asset is used in operations.

Estimated Useful Life and Residual Value

When calculating depreciation, the company must estimate:

- Useful life: the period over which the asset is expected to provide economic benefits
- Residual value: the estimated amount the asset will be worth at the end of its useful life

Suppose Pharoah Company estimates the machinery's useful life to be 10 years with a residual value of \$9,136 (10% of the cost). These estimates are critical for depreciation calculations.

Depreciation Methods

Common methods include:

1. **Straight-Line Method:** Equal depreciation expense each year
2. **Declining Balance Method:** Higher depreciation expense in early years
3. **Units of Production Method:** Depreciation based on usage or output

For simplicity, let's assume Pharoah Company adopts the straight-line method.

Calculating Annual Depreciation

Using the straight-line method:

$$\begin{aligned}\text{Depreciation Expense} &= (\text{Cost} - \text{Residual Value}) / \text{Useful Life} \\ &= (\$91,360 - \$9,136) / 10 \text{ years} \\ &= \$82,224 / 10 \\ &= \$8,222.40 \text{ per year}\end{aligned}$$

Since the machine was purchased on October 1, 2022, depreciation for the first year (2022) will be for 3 months:

$$\text{First Year Depreciation} = \$8,222.40 \times (3/12) = \$2,055.60$$

Subsequent annual depreciation expenses will be \$8,222.40.

Financial Reporting Implications

Impact on Financial Statements

The purchase and depreciation of the machine affect various financial statement components:

- **Balance Sheet:** Increase in assets by the cost of the machinery; accumulated depreciation reduces net book value
- **Income Statement:** Depreciation expense reduces net income each period

Asset Turnover and Profitability Ratios

The new machinery can improve asset turnover ratios by increasing production capacity, potentially leading to higher sales. It also impacts profitability ratios as depreciation expenses are recognized.

Tax Considerations

Tax Depreciation and Deductions

Tax laws often allow accelerated depreciation methods, such as Modified Accelerated Cost Recovery System (MACRS) in the U.S., which may enable Pharoah Company to recover the asset's cost faster for tax purposes.

Impact on Taxable Income

Accelerated depreciation reduces taxable income in the early years, providing cash flow benefits. The company must differentiate between financial reporting depreciation and tax depreciation.

Additional Considerations for Pharoah Company

Impairment and Revaluation

Regular assessments should be conducted to determine if the machinery's carrying amount exceeds its recoverable amount. If impairment occurs, write-downs are necessary.

Maintenance and Repairs

Ongoing maintenance costs are expensed as incurred, whereas improvements that extend the asset's useful life should be capitalized.

Disposal and Replacement

When the machinery reaches the end of its useful life or becomes obsolete, it should be disposed of. Gains or losses on disposal are recognized in the income statement.

Conclusion

Pharoah Company's purchase of a new machine on October 1, 2022, at a cost of \$91,360 marks a strategic investment that will influence its operational efficiency and financial statements for years to come. Proper accounting treatment involves capitalizing the asset, accurately calculating depreciation, and considering tax implications. Understanding these elements ensures compliance with accounting standards and provides valuable insights into the company's financial health and operational capacity.

Key Takeaways

- All costs directly attributable to acquiring and preparing the machinery should be capitalized
- Depreciation methods and estimates significantly impact financial reporting
- Regular reviews for impairment and appropriate disposal procedures are essential
- Tax depreciation may differ from financial depreciation, impacting cash flow

This comprehensive overview highlights the importance of meticulous accounting for machinery purchases like that of Pharaoh Company and underscores the broader financial and strategic implications. Properly managed, such investments can support sustainable growth and operational excellence.

Frequently Asked Questions

What is the initial journal entry for Pharaoh Company's purchase of the new machine on October 1, 2022?

The initial journal entry would debit the Machinery account for \$91,360 and credit Cash or Accounts Payable for the same amount to record the purchase.

How should Pharaoh Company estimate the useful life of the new machine purchased on October 1, 2022?

The company should base the estimate on industry standards, manufacturer guidelines, or historical data, and it is typically disclosed in the company's financial notes.

What depreciation method should Pharaoh Company use for the new machine, and how does the purchase date affect depreciation calculation?

The company can choose methods like straight-line or declining balance. Since the machine was purchased on October 1, 2022, depreciation should be prorated for the first year based on the purchase date.

How does the purchase of this machine impact Pharaoh Company's financial statements in 2022 and subsequent years?

In 2022, the company will record depreciation expense for three months (October to December). In

subsequent years, depreciation expense will be recorded annually until the asset is fully depreciated.

What factors should Pharaoh Company consider when estimating the salvage value of the new machine?

The company should consider industry standards, the expected residual value at the end of its useful life, and potential technological obsolescence when estimating salvage value.

What are the tax implications of purchasing a new machine at a cost of \$91,360 for Pharaoh Company?

The purchase may qualify for depreciation deductions, which can reduce taxable income. The company should follow applicable tax laws and depreciation schedules to maximize tax benefits.

Additional Resources

Pharaoh Company's Acquisition of a New Machine on October 1, 2022: A Comprehensive Review

Purchasing new equipment is a significant decision for any company, and for Pharaoh Company, acquiring a new machine on October 1, 2022, at a cost of \$91,360 represents a strategic investment in operational capacity and efficiency. This article explores the various facets of this purchase, including the financial implications, accounting treatment, depreciation considerations, and broader impact on the company's financial statements.

Understanding the Purchase Details

Basic Information

- Purchase Date: October 1, 2022
- Purchase Price: \$91,360
- Type of Asset: Machinery (likely classified as a fixed asset)
- Purpose of Acquisition: (Assumed to be for manufacturing, production, or operational efficiency; specifics depend on company context)

Significance of the Purchase

Acquiring a new machine can:

- Increase production capacity
- Improve operational efficiency

- Reduce costs in the long-term
- Enable adoption of new technology or processes
- Impact financial statements through depreciation, capital expenditure, and cash flow implications

Financial Implications of the Purchase

Cash Flow Impact

- The purchase represents an outflow of cash of \$91,360.
- If financed through debt or leasing, the cash flow effects would differ, involving interest payments or lease expenses.
- It's important to note whether the purchase was outright cash purchase or financed, as it influences liquidity and solvency ratios.

Capital Expenditure vs. Operating Expense

- The acquisition of machinery is classified as a capital expenditure (CapEx), meaning it adds to the company's fixed assets.
- Unlike operating expenses, CapEx is capitalized and depreciated over its useful life.

Accounting Treatment of the Machine

Initial Recognition

According to accounting standards (e.g., IFRS, GAAP), the machine should be recorded at its cost, which includes:

- Purchase price: \$91,360
- Any additional costs necessary to bring the asset to its intended use, such as:
 - Transportation costs
 - Installation and setup costs
 - Testing expenses before operational use

Assuming no additional costs are provided, the initial journal entry might be:

...

Dr. Machinery (Asset) \$91,360
 Cr. Cash (or Accounts Payable) \$91,360

...

Subsequent Measurement

- The machinery will be recorded at cost minus accumulated depreciation.
- The company must determine the useful life of the asset and its residual value (if any).
- Depreciation expense will systematically allocate the cost over its useful life.

Estimating the Useful Life and Depreciation

Estimating Useful Life

Key considerations include:

- Manufacturer's specifications
- Industry standards
- Company policy
- Technological obsolescence
- Maintenance records

Suppose Pharoah Company estimates the useful life of the machine to be 10 years with a residual value of \$9,136 (10% of initial cost), for example.

Depreciation Methods

Common methods include:

- Straight-Line Method: Equal expense each year
- Declining Balance Method: Accelerated depreciation
- Units of Production Method: Based on usage

For simplicity, assume the straight-line method:

- Annual Depreciation Expense:

$$\begin{aligned} & \frac{\text{Cost} - \text{Residual Value}}{\text{Useful Life}} = \frac{91,360 - 9,136}{10} = \\ & \frac{82,224}{10} = 8,222.40 \end{aligned}$$

- Depreciation for the first period (October 1, 2022, to December 31, 2022):

Since the purchase was made on October 1, the depreciation period for 2022 is 3 months.

- Depreciation expense for 2022:

$$\frac{\$8,222.40}{12} \times 3 = \$2,055.60$$

The journal entry:

Dr. Depreciation Expense \$2,055.60

Cr. Accumulated Depreciation \$2,055.60

- For subsequent full years, depreciation expense will be \$8,222.40 annually.

Impact on Financial Statements

Balance Sheet Effects

- Increase in machinery (asset) by \$91,360
- Decrease in cash or increase in liabilities by \$91,360
- Over time, accumulated depreciation reduces the book value of the asset

Income Statement Effects

- Depreciation expense reduces net income
- For 2022, depreciation expense is \$2,055.60 (partial year)
- Future years will record \$8,222.40 annually, impacting profitability

Cash Flow Statement

- The cash outflow at purchase is reflected under investing activities
- Depreciation is a non-cash expense, added back in cash flow from operating activities

Additional Considerations

Tax Implications

- Depreciation reduces taxable income
- The company should consider applicable tax laws, which may allow accelerated depreciation or bonus depreciation
- Exact tax savings depend on jurisdiction and depreciation policies

Maintenance and Operating Costs

- Post-purchase, the machine will incur ongoing operational costs such as:
- Maintenance and repairs
- Utility costs
- Staffing and operational expenses

These costs impact operating income and should be budgeted accordingly.

Asset Management and Monitoring

- Regular inspections to ensure proper functioning
- Tracking usage and efficiency
- Planning for eventual replacement or upgrade

Strategic and Operational Impact

Efficiency Gains

- The new machine may feature advanced technology, leading to higher productivity
- Reduced downtime or waste
- Improved quality or product consistency

Capacity Expansion

- Enables the company to meet increased demand
- Potential to enter new markets or increase market share

Cost Savings

- Lower labor or material costs

- Energy efficiency improvements

Long-term Asset Management

- The company must track the asset's useful life and plan for useful life end-of-life considerations
- Disposal or sale of the equipment at the end of its useful life
- Recording gains or losses on disposal based on book value vs. sale price

Conclusion: A Strategic Investment with Accounting Nuances

Pharoah Company's purchase of a new machine at \$91,360 on October 1, 2022, marks a pivotal step toward operational enhancement. Proper accounting treatment, including initial recognition, depreciation, and subsequent management, ensures the company's financial statements accurately reflect the asset's value and impact.

The estimated useful life, residual value, and depreciation method chosen significantly influence financial reporting and tax outcomes. Additionally, understanding the broader operational benefits—such as increased capacity, efficiency, and potential cost savings—highlights the strategic importance of this investment.

Ultimately, the effective management of this asset involves not just initial acquisition but ongoing maintenance, monitoring, and eventual disposition, all of which contribute to the company's long-term financial health and competitive positioning.

In summary, acquiring a new machine involves a careful balance of financial accounting, strategic planning, and operational management. The initial cost, depreciation policies, and usage assumptions all interplay to shape the company's financial landscape, making thorough understanding and diligent management essential for maximizing the investment's value.

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