

Mohr Company Purchases A Machine At The Beginning Of The Year At A Cost Of \$31,000. The Machine Is Depreciated

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When Mohr Company makes an investment in equipment, understanding the depreciation process is essential for accurate financial reporting and tax compliance. Purchasing a machine at the start of the year at a cost of \$31,000 initiates a systematic process of depreciation, which allocates the machine's cost over its useful life. This comprehensive guide explores the key concepts, methods, and implications of depreciation for Mohr Company, ensuring clarity for accounting professionals, business owners, and stakeholders.

Understanding the Purchase of the Machine

Initial Cost and Capitalization

- The purchase price of \$31,000 represents the initial capitalized cost of the machine.
- This cost includes all expenses necessary to acquire the asset and prepare it for use, such as:
 - Purchase price
 - Shipping and transportation costs

- Installation and setup fees

- The total capitalized amount becomes the basis for depreciation calculations.

Significance of Starting Depreciation at Purchase

- Since the machine is purchased at the beginning of the year, depreciation can be calculated for a full year, simplifying accounting.
- The timing impacts tax deductions and financial statements, influencing Mohr Company's reported net income.

Depreciation Methods Applicable to Mohr Company

There are various methods available to depreciate assets. The choice depends on the nature of the asset, company policies, and applicable accounting standards.

Straight-Line Method

- The most straightforward approach, spreading the cost evenly over the useful life.
- Formula:

Depreciation Expense = (Cost – Salvage Value) / Useful Life

- Example:
- If the machine has a salvage value of \$3,000 and a useful life of 5 years:

- Annual Depreciation = $(\$31,000 - \$3,000) / 5 = \$5,600$

Declining Balance Method

- Accelerated depreciation method that applies a fixed rate to reducing book value.
- Commonly used rates:
- Double Declining Balance (DDB): $2 / \text{Useful Life}$
- Benefits:
- Larger depreciation expenses in early years, aligning with potential higher usage or obsolescence.

Units of Production Method

- Depreciation based on actual usage or output.
- Suitable for machinery where wear and tear correlates with activity levels.

Calculating Depreciation for Mohr Company's Machine

Given the purchase details, Mohr Company must select an appropriate depreciation method.

Assumptions for Calculation

- Cost of the machine: \$31,000
- Salvage value: \$3,000 (assumed)
- Useful life: 5 years
- Depreciation method: Straight-line

Full Year Depreciation

- Annual depreciation expense:

- $(\$31,000 - \$3,000) / 5 = \$5,600$

- This expense will be recorded annually, starting at the beginning of the year.

Journal Entry at Purchase

- No depreciation entry is made at the time of purchase.
- Depreciation expense is recorded annually:

Debit: Depreciation Expense \$5,600

Credit: Accumulated Depreciation \$5,600

- Over time, accumulated depreciation increases, reducing the book value of the asset.

Impact of Depreciation on Financial Statements

Balance Sheet

- The original asset is reported at its cost minus accumulated depreciation.
- Book value at the end of each year:
- Year 1: $\$31,000 - \$5,600 = \$25,400$
- Year 2: $\$25,400 - \$5,600 = \$19,800$
- And so on, until salvage value is reached.

Income Statement

- Depreciation expense reduces net income.
- Reflects the consumption of the asset's economic benefits over time.

Tax Implications

- Depreciation is a deductible expense, reducing taxable income.
- Accelerated methods like declining balance can lead to higher deductions in early years.

Additional Considerations in Depreciation

Residual or Salvage Value

- Estimated value at the end of useful life.
- It is subtracted from the cost to determine total depreciable amount.

Useful Life

- An estimate of the period the asset will generate revenue.
- Must be reviewed periodically for accuracy.

Impairment and Revaluation

- If the asset's market value drops below book value, impairment expenses may be necessary.
- Revaluation is typically not permitted under standard accounting unless using specialized revaluation models.

Tax Regulations and Depreciation

- Different jurisdictions have specific rules for depreciation.
- Mohr Company needs to comply with local tax laws, which may favor accelerated depreciation for tax

benefits.

Strategic Implications of Depreciation for Mohr Company

Financial Planning and Analysis

- Accurate depreciation helps in budgeting for replacements and maintenance.
- Impacts profitability metrics and financial ratios.

Tax Planning

- Choosing appropriate depreciation methods can optimize tax savings.
- Accelerated depreciation methods can improve cash flow in early years.

Asset Management

- Regular depreciation tracking aids in monitoring asset health and planning for upgrades or disposals.

Conclusion

Mohr Company's decision to purchase a machine at a cost of \$31,000 and to depreciate it over its useful life is a fundamental aspect of sound financial management. Employing appropriate depreciation methods ensures that the expenses are accurately reflected in financial statements, providing

stakeholders with a true picture of the company's financial health. Whether using the straight-line method for simplicity or accelerated methods for tax benefits, Mohr Company must adhere to relevant standards and regulations. Proper depreciation accounting not only supports compliance but also enhances strategic decision-making regarding asset utilization, replacement planning, and tax planning.

In summary, understanding the depreciation process—from initial purchase to ongoing expense recognition—is vital for maximizing the value derived from capital assets and maintaining transparent financial reporting.

Frequently Asked Questions

What depreciation method is typically used to depreciate the machine purchased by Mohr Company at the beginning of the year?

Mohr Company commonly uses methods like straight-line or declining balance depreciation to allocate the cost of the machine over its useful life.

How does the purchase of a machine at \$31,000 impact Mohr Company's financial statements?

The purchase increases assets on the balance sheet and, through depreciation, reduces net income over time, reflecting the expense associated with the machine.

What is the journal entry to record the purchase of the machine at the beginning of the year?

Debit Machinery \$31,000 and credit Cash (or Accounts Payable) \$31,000 to record the purchase of the machine.

How is depreciation expense calculated for the machine during the year?

It depends on the chosen method; for straight-line depreciation, divide the cost (\$31,000) by the estimated useful life to determine annual expense.

What factors influence the depreciation period of Mohr Company's machine?

Factors include the estimated useful life of the machine, its expected salvage value, and the company's depreciation policy.

How does depreciation affect Mohr Company's taxable income?

Depreciation expense reduces taxable income, potentially lowering the company's tax liability for the year.

What are the implications if Mohr Company decides to sell the machine before the end of its useful life?

The company would need to record the sale, remove the asset from books, and recognize any gain or loss based on the asset's book value and sale price.

Additional Resources

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Introduction

In the realm of manufacturing and business operations, acquiring machinery is a significant investment that impacts a company's financial statements, operational efficiency, and long-term profitability. When Mohr Company procures a machine at the beginning of the year for \$31,000, it sets off a series of accounting and operational considerations, primarily concerning depreciation. This detailed review explores the multifaceted aspects of this purchase and the subsequent depreciation process, providing insights into its implications on financial reporting, tax considerations, and managerial decision-making.

Understanding the Purchase of Machinery

1. Nature of the Asset

The machine purchased by Mohr Company qualifies as a long-term asset or property, plant, and equipment (PP&E). Such assets are:

- Used in the production or operational activities.
- Expected to provide economic benefits over multiple accounting periods.
- Capitalized on the balance sheet at their original cost, which includes the purchase price and related costs necessary to bring the asset to operational readiness.

2. Purchase Cost Breakdown

The total cost of \$31,000 encompasses:

- Purchase Price: The agreed-upon price for the machine itself.
- Transportation Costs: Expenses related to transporting the machine to Mohr's facility.
- Installation and Setup Costs: Expenses incurred to install, test, and make the machine operational.
- Legal and Registration Fees: Any applicable taxes, registration, or legal costs associated with the purchase.

Accurately capitalizing these costs ensures compliance with accounting standards and provides a true reflection of the asset's value.

3. Recording the Purchase

At the time of purchase, Mohr Company records:

- Debit: Machinery (Asset account) for \$31,000.
- Credit: Cash or Accounts Payable for \$31,000.

This journal entry recognizes the acquisition and sets the foundation for subsequent depreciation calculations.

Depreciation: Conceptual Framework

1. What Is Depreciation?

Depreciation is a systematic allocation of the cost of a tangible asset over its useful life. It reflects the wear and tear, obsolescence, or usage that diminishes the asset's value over time.

2. Why Is Depreciation Important?

- Matching Principle: Ensures expenses are recognized in the same period as the revenues they help generate.
- Tax Deduction: Provides a means for tax planning by deducting depreciation expenses.
- Asset Management: Helps track the book value of assets over time.

3. Depreciation Methods

Mohr Company has options to choose from, each with implications:

- Straight-Line Method: Equal expense allocation over useful life.
- Declining Balance Method: Accelerated depreciation, higher expenses in early years.
- Units of Production Method: Based on usage or output.
- Sum-of-the-Years'-Digits: Accelerated, but less common.

The choice depends on the nature of the asset, company policy, and tax regulations.

Determining the Depreciation Method and Life

1. Selecting the Appropriate Method

For machinery purchased at the beginning of the year, the most common approach is the straight-line method, which simplifies calculations and aligns with the asset's usage pattern in many cases.

2. Estimating Useful Life

- Typical machinery might have a useful life of 5, 7, or 10 years.
- Mohr Company should assess factors such as technological obsolescence, physical wear, and industry standards.
- For this review, assume a 10-year useful life with no salvage value, unless specified otherwise.

3. Calculating Annual Depreciation

Using the straight-line method, the annual depreciation expense is:

$$\text{Depreciation Expense} = \frac{\text{Cost of Asset} - \text{Salvage Value}}{\text{Useful Life}}$$

Assuming no salvage value:

$$\frac{\$31,000}{10} = \$3,100 \text{ per year}$$

This means Mohr Company would record a depreciation expense of \$3,100 annually over ten years.

Impacts on Financial Statements

1. Income Statement

- The depreciation expense reduces net income.
- Each year, Mohr will report \$3,100 as depreciation expense, impacting profitability.

2. Balance Sheet

- The book value of the asset decreases annually by the depreciation expense.
- After one year, the book value will be:

$$\begin{aligned} & \backslash \\ & \$31,000 - \$3,100 = \$27,900 \\ & \backslash \end{aligned}$$

- Over time, this continues until the asset reaches its salvage value or is fully depreciated.

3. Cash Flow Statement

- Depreciation is a non-cash expense; it does not affect cash flow directly.
- However, tax savings resulting from depreciation reduce taxable income, indirectly impacting cash flows.

Tax Implications

1. Depreciation and Tax Deductions

- Depreciation allows Mohr Company to deduct the expense from taxable income.
- Accelerated methods (e.g., declining balance) can lead to higher deductions in early years, improving cash flow.

2. Tax Regulations and Policies

- Tax authorities often have prescribed methods or limits.
- Mohr should consult relevant tax codes to ensure compliance and optimize deductions.

3. Asset Disposal and Recapture

- When the machine is sold or disposed of, any remaining book value may be subject to gain or loss recognition.
- Depreciation recapture rules may apply, affecting taxable income.

Accounting for Depreciation in Practice

1. Journal Entries

Annually, Mohr will record:

- Debit: Depreciation Expense (income statement) for \$3,100.
- Credit: Accumulated Depreciation (contra-asset account) for \$3,100.

This accumulation reduces the asset's net book value on the balance sheet.

2. Tracking and Record-Keeping

- Maintain detailed records of purchase costs, depreciation schedules, and disposals.
- Use asset management software or depreciation schedules for accuracy.

3. Reassessing Useful Life and Residual Value

- Periodically review assumptions.
- Changes may necessitate adjustments to depreciation calculations.

Other Considerations and Best Practices

1. Impairment of Assets

- If the machine's market value drops below its book value due to damage or obsolescence, impairment losses should be recognized.

2. Capital Improvements vs. Repairs

- Improvements that extend the machine's life or increase its value should be capitalized.
- Routine repairs are expensed as incurred.

3. Disposal of the Asset

- When the machine reaches the end of its useful life or is sold, record gain or loss based on the difference between sale proceeds and book value.

4. Tax Planning Strategies

- Consider accelerated depreciation methods if cash flow optimization is a priority.
- Evaluate the timing of asset purchases for tax benefits.

5. Compliance with Accounting Standards

- Follow Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), depending on jurisdiction.

Conclusion

The purchase of a machine by Mohr Company at \$31,000 at the beginning of the year exemplifies a

fundamental aspect of business asset management—balancing operational needs with sound financial practices. Properly accounting for depreciation is crucial for accurate financial reporting, tax compliance, and strategic decision-making.

Selecting an appropriate depreciation method, estimating useful life, and maintaining meticulous records ensure the company maximizes its tax benefits and accurately reflects its asset value. Over time, the systematic allocation of the asset's cost through depreciation provides a clearer picture of the company's financial health and operational efficiency.

Ultimately, Mohr Company's approach to depreciation reflects best practices in accounting and asset management, fostering transparency and supporting long-term business sustainability. Properly managed, depreciation not only serves as an accounting tool but also as a strategic lever for optimizing financial performance and planning future investments.

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