The Adviser: Picking the Right Depreciation

The Adviser *is a monthly activity where you take on the role of an accounting guru whose expertise will help local businesses. It is your job to make sure your clients are on the path to financial success.*

As the Adviser, you were recently contacted by Lamar Bermuda, owner of Lamar's Lawn Care Service.

Over the past year, Lamar's business has been booming. In fact, it has been so busy that Lamar has expanded his business. He purchased a new commercial-grade lawnmower for $14,000 on January 1, which he expects will last for five years. Although Lamar can afford this new expense, he's worried it will greatly reduce his net income for the year.

After hearing Lamar's dilemma, you recommend he calculate the newly purchased lawnmower as an asset on his balance sheet and then use a depreciation method to show how it has decreased in value over time due to wear and tear. There are three common depreciation methods you decide to evaluate: *Straight Line Depreciation*, *Reducing Balance Depreciation* and *Units of Activity Depreciation*. As the Adviser, you will need to figure out which depreciation method makes the most sense for your client.

Use the worksheet below to work through the three depreciation methods and provide the recommendation Lamar needs for his lawn care company.

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Picking the Right Depreciation Worksheet

Method	Straight-Line Depreciation	Double Declining Balance Depreciation	Units of Activity Depreciation
Definition			
Formula			

Straight Line Depreciation – Commercial Lawn Mower: Acquired January 1. Purchased for $14,000; salvage value is $2,000. Useful life is 5 years. Remember: the asset cannot depreciate below its salvage value.

1. How is the depreciable cost for the straight-line method computed?

2. What is the depreciable cost amount?

3. Show your computation to calculate the annual depreciation expense.

4. Complete the following Straight Line Depreciation table:

Year	Opening Value	Depreciation Expense	Net Book Value

5. What pattern is clear for the annual depreciation expense under the straight line method?

6. What would change if the equipment was purchased on July 1 instead of January 1?

7. Create an updated chart to reflect equipment purchased on July 1.

Year	Opening Value	Depreciation Expense	Net Book Value

Double Declining Balance Method – Commercial Lawn Mower: Acquired January 1. Purchased for $14,000; salvage value is $2,000. Useful life is 5 years.

1. Is the salvage value used to compute book value (circle the answer)? **YES** **NO**

2. How is the double declining rate computed?

3. Complete the following DDB table:

Year	Book Value: Start of Year	DDB Percent	Annual Depreciation Expense	Accumulated Depreciation	Book Value: End of Year
Year 1					
Year 2					
Year 3					
Year 4					
Year 5					

4. What amount must the balance in the accumulated depreciation account equal in year 4?

5. In which year does the Straight Line Depreciation expense exceed the Double-Declining Balance Depreciation?

6. How does the depreciation requirement alter calculations in year 4?

Units of Activity – Commercial Lawn Mower: Acquired January 1. Purchased for $14,000; salvage value is $2,000. Useful life is 5 years. Total units of activity = 6,250 hours.

1. What is the depreciable cost amount?

2. Show your computation to calculate the depreciation rate per hour.

3. Will the depreciation rate change from year to year? **YES** **NO**

4. Complete the following Units of Activity Depreciation table for the first five years they use the equipment:

Year	Hours Used	Depreciation Rate Per Hour	Annual Depreciation Expense	Accumulated Depreciation Balance	Book Value
Year 1	950				
Year 2	845				
Year 3	1,250				
Year 4	1,555				
Year 5	1650				

5. What is the accumulated depreciation balance for the asset at the end of year 3?

6. What must the book value equal at the end of year 5?

For the next set of questions, use the three depreciation tables to help figure out the answer.

1. Which method results in the greatest depreciation expense being recorded in the earlier years of use?

   A) Straight-line

   B) Units of Activity

   C) Double Declining Balance

2. In terms of net income reported on the income statement, which depreciation method will report the smallest income amount in year 1?

3. Which depreciation method will report the largest net income in year 2?

4. For Year 3, which company will report the largest book value for the asset on the balance sheet?

5. Based on the worksheet, which depreciation method would you recommend to Lamar Bermuda for calculating his new lawnmower?