

9.2: Entries for Cash and Lump-Sum Purchases of Property, Plant and Equipment

Property, plant, and equipment (fixed assets or operating assets) compose more than one-half of total assets in many corporations. These resources are necessary for the companies to operate and ultimately make a profit. It is the efficient use of these resources that in many cases determines the amount of profit corporations will earn.

On a classified balance sheet, the asset section contains: (1) current assets; (2) property, plant, and equipment; and (3) other categories such as intangible assets and long-term investments. Previous chapters discussed current assets. Property, plant, and equipment are often called **plant and equipment** or simply plant assets. Plant assets are long-lived assets because they are expected to last for more than one year. Long-lived assets consist of tangible assets and intangible assets. **Tangible assets** have physical characteristics that we can see and touch; they include plant assets such as buildings and furniture, and natural resources such as gas and oil. **Intangible assets** have no physical characteristics that we can see and touch but represent exclusive privileges and rights to their owners.

Nature of plant assets

To be classified as a plant asset, an asset must: (1) be tangible, that is, capable of being seen and touched; (2) have a useful service life of more than one year; and (3) be used in business operations rather than held for resale. Common plant assets are buildings, machines, tools, and office equipment. On the balance sheet, these assets appear under the heading “Property, plant, and equipment”.

Initial recording of plant assets

When a company acquires a plant asset, accountants record the asset at the cost of acquisition (historical cost). When a plant asset is purchased for cash, its acquisition cost is simply the agreed on cash price. This cost is objective, verifiable, and the best measure of an asset’s fair market value at the time of purchase. **Fair market value** is the price received for an item sold in the normal course of business (not at a forced liquidation sale). Even if the market value of the asset changes over time, accountants continue to report the acquisition cost in the asset account in subsequent periods.

The **acquisition cost** of a plant asset is the amount of cost incurred to acquire and place the asset in operating condition at its proper location. Cost includes all normal, reasonable, and necessary expenditures to obtain the asset and get it ready for use. Acquisition cost also includes the repair and reconditioning costs for used or damaged assets as long as the item was not damaged after purchase. Unnecessary costs (such as traffic tickets or fines or repairs that occurred after purchase) that must be paid as a result of hauling machinery to a new plant are not part of the acquisition cost of the asset.

Recording Land

The cost of land includes its purchase price and other many other costs including:

- real estate commissions,
- title search and title transfer fees,
- title insurance premiums,
- existing mortgage note or unpaid taxes (back taxes) assumed by the purchaser,
- costs of surveying, clearing, and grading;
- and local assessments for sidewalks, streets, sewers, and water mains.
- Sometimes land purchased as a building site contains an unusable building that must be removed.

The accountant debits the entire costs to Land, including the cost of removing the building less any cash received from the sale of salvaged items while the land is being readied for use. **Land is considered to have an unlimited life and is therefore not depreciable.** However, land improvements, including driveways, temporary landscaping, parking lots, fences, lighting systems, and sprinkler systems, are attachments to the land. They have limited lives and therefore are depreciable. Owners record depreciable land improvements in a separate account called Land Improvements. They record the cost of permanent landscaping, including leveling and grading, in the Land account.

To illustrate, assume that Spivey Company purchased an old farm on the outskirts of San Diego as a factory site. The company paid \$225,000 for the property. In addition, the company agreed to pay unpaid property taxes from previous periods (called back taxes) of \$12,000. Attorneys’ fees and other legal costs relating to the purchase of the farm totaled \$1,800. Spivey demolished (razed) the farm buildings at a cost of \$18,000. The company salvaged some of the structural pieces of the building and sold them for \$3,000.

Because the firm was constructing a new building at the site, the city assessed Spivey Company \$9,000 for water mains, sewers, and street paving. Spivey computed the cost of the land as follows:

Cost of factory site	\$225,000
Back taxes	12,000
Attorneys' fees and other legal costs	1,800
Demolition	18,000
Sale of salvaged parts	-3,000
City assessment	<u>9,000</u>
Total Land Cost	\$262,800

The journal entry to record the purchase of this land for cash would be:

	Debit	Credit
Land	262,800	
Cash		262,800
To record purchase of land with cash.		

Recording Building

When a business buys a building, its cost includes:

- the purchase price,
- repair and remodeling costs,
- unpaid taxes assumed by the purchaser,
- legal costs,
- and real estate commissions paid.

Determining the cost of constructing a new building is often more difficult. Usually this cost includes architect's fees; building permits; payments to contractors; and the cost of digging the foundation. Also included are labor and materials to build the building; salaries of officers supervising the construction; and insurance, taxes, and interest during the construction period. Any miscellaneous amounts earned from the building during construction reduce the cost of the building. For example, an owner who could rent out a small completed portion during construction of the remainder of the building, would credit the rental proceeds to the Buildings account rather than to a revenue account.

Recording Equipment or Machinery

Often companies purchase machinery or other equipment such as delivery or office equipment. Its cost includes:

- the seller's net invoice price (whether the discount is taken or not),
- transportation charges incurred,
- insurance in transit,
- cost of installation,
- costs of accessories,
- and testing costs.
- Also included are other costs needed to put the machine or equipment in operating condition in its intended location.

The cost of machinery does not include removing and disposing of a replaced, old machine that has been used in operations. Such costs are part of the gain or loss on disposal of the old machine.

To illustrate, assume that Clark Company purchased new equipment to replace equipment that it has used for five years. The company paid a net purchase price of \$150,000, brokerage fees of \$5,000, legal fees of \$2,000, and freight and insurance in transit

of \$3,000. In addition, the company paid \$1,500 to remove old equipment and \$2,000 to install new equipment. Clark would compute the cost of new equipment as follows:

Net purchase price	\$150,000
Brokerage fees	5,000
Legal fees	2,000
Freight and insurance in transit	3,000
Installation costs	<u>2,000</u>
Total Equipment cost	\$162,000

The journal entry to record the purchase of the equipment paying \$50,000 cash and by signing a note for the balance would be:

	Debit	Credit
Equipment	162,000	
Cash		50,000
Note Payable (162,000 – 50,000)		162,000
To record purchase of equipment by paying cash and signing note.		

Lump Sum Purchases

Sometimes a company buys land and other assets for a lump sum. When land and buildings purchased together are to be used, the firm divides the total cost and establishes separate ledger accounts for land and for buildings. This division of cost establishes the proper balances in the appropriate accounts. This is especially important later because the depreciation recorded on the buildings affects reported income, while no depreciation is taken on the land.

Let's look at an example: Assume a company purchases land, machinery and a building for \$4,000,000 cash. The land has a market value of \$1,350,000, machinery of \$675,000 and the building for \$2,475,000 for a total value of \$4,500,000. We cannot report the assets at market value since the market value is less than we paid for the assets. We will do a 2-step process to get the cost of each asset.

1. Calculate each asset's percent of market value (Asset market value / total market value of all assets)

Asset	Appraisal (or	Market) Value	% of MV
Land	1,350,000	/4,500,000 =	30%
Machinery	675,000	/4,500,000 =	15%
Building	2,475,000	/4,500,000 =	55%
Total	<u>4,500,000</u>		

2. Calculate the cost of each asset (total price paid for all assets x % of market value)

Asset	% of MV	Purchase Price	Asset Cost
Land	30%	4,000,000	\$ 1,200,000
Machinery	15%	4,000,000	\$ 600,000
Building	55%	4,000,000	<u>\$ 2,200,000</u>
Total			\$ 4,000,000

The journal entry to record this purchase for cash would be:

Account	Debit	Credit
Land	\$ 1,200,000	
Machinery	600,000	
Building	2,200,000	
Cash		\$ 4,000,000

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