

(Remember that the process of measuring the annual profit is in any event one of estimation – a question of trying to work out what proportion of the firm's lifetime profit was earned in that 12-month period.)

There are several methods used to calculate depreciation on a systematic basis to match the expensing of the asset with its use. Broadly these fall into one or other of two kinds: those which allocate over time and those which try to match depreciation to use.

With the time-based approach, having arrived at the acquisition value of the asset, an estimate is made both of the likely working life of the asset within the company and of its expected scrap or salvage value at the end of that working life. The difference between the original asset cost and the expected scrap value is called the 'depreciable amount' of the asset – that is, the total expense to be allocated over the working life. One of the methods we shall now consider will then be selected to allocate the depreciable amount over the working life of the asset. We shall look first at these methods, and then at the way in which depreciation is reported in the financial statements.

### Straight-line depreciation

This method is the one most favoured by companies, probably because it is the simplest and easiest to use. The straight-line method, as its name implies, assumes that the use of the asset is uniform throughout its working life, and therefore allocates the expense accordingly.

The annual expense (annual depreciation) is found simply:

$$\frac{\text{Depreciable amount}}{\text{Estimated useful life}} = \text{Annual depreciation expense}$$

For example, supposing a company buys desks and other office furniture for €5000, and estimates that they will be used for 10 years and have no scrap value. The annual depreciation would be charged as follows:

Depreciable amount: €5 000 less 0 = €5 000

Useful life: 10 years

Annual depreciation charge:  $\frac{5\,000}{10} = €500$

This method is most appropriate to assets whose consumption takes place in a uniform manner. Examples of this would be assets such as a shop front, a building, a lease premium, furniture, and so on.

### Diminishing balance method

A method which allocates a high proportion of expense in the early life of the asset is the diminishing balance method (also called reducing balance method). This uses a method which gives a geometric reduction in the charge in succeeding years. A basic difference is that the annual depreciation charge is