Depreciation Methods: Straight Line

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There are several ways in which depreciation can be calculated but the most common is called the straight-line method.

This results in a fixed amount of depreciation being calculated each year.

The cost of the asset less its residual value (if any) is divided by the number of years of its expected useful life.

Take the example of a business purchasing equipment. The equipment will operate for 5 years and…..

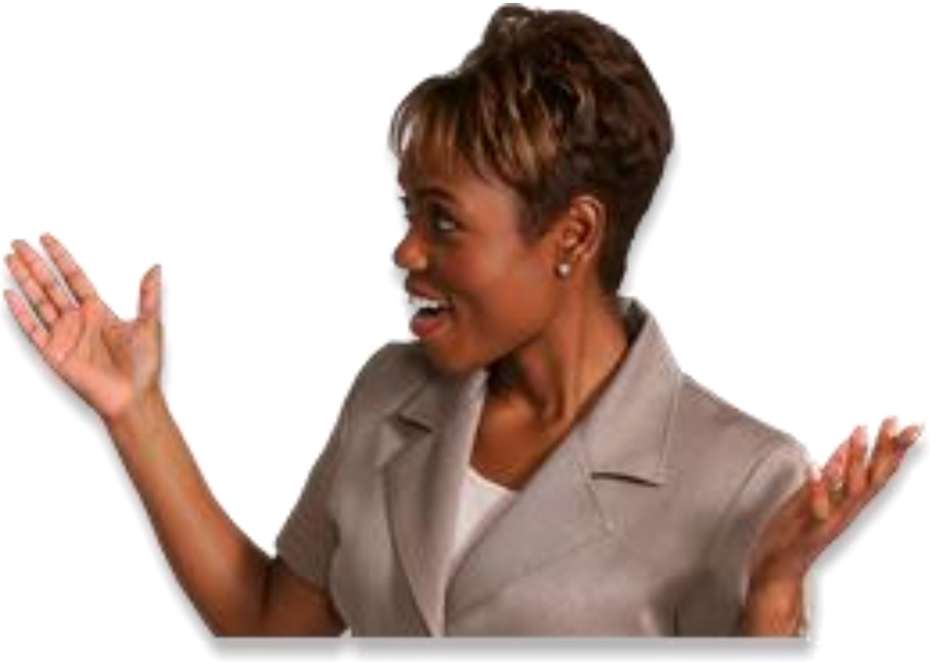
…..over that time will improve either the business's production efficiency and, hopefully, reduce expenses, or increase the business' outputs and, possibly, increase its revenue.

So, in some way, the business will benefit financially from owning the equipment for the full 5 years.

Let’s assume that the purchase price of the equipment was 100,000.

Is it reasonable to expect that the entire cost of the equipment should be included as an expense in the accounting period in which it was purchased?

Clearly not, as the business will generate profits in future years as a result of owning the equipment.



To make the calculation of the amount of depreciation for a particular asset, the business would need to determine;

firstly, the cost of the asset

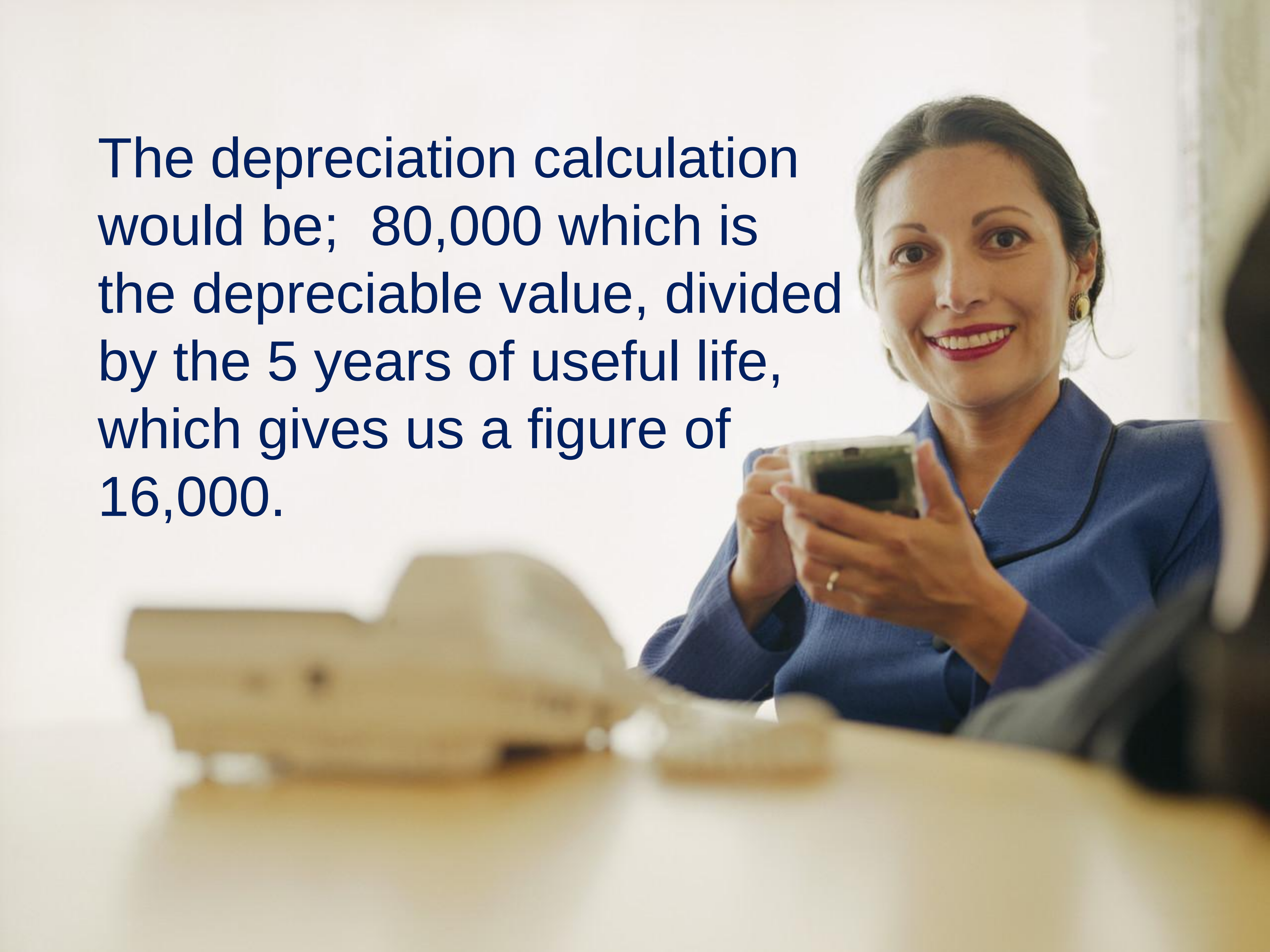
secondly, the expected useful life of the asset measured by time

and thirdly, any residual value. This is an estimate of what the asset's value would be at the end of its useful life For example, it might be the scrap value if the asset is a piece of equipment.

Let’s say that in our example of equipment costing 100,000, the directors of the business estimate a residual value of 20,000 and a useful life of 5 years.

The value of the asset to be depreciated (that is; its depreciable value) is therefore, 100,000 minus the 20,000 residual value which results in a depreciable value of 80,000.

The depreciation calculation would be; 80,000 which is the depreciable value, divided by the 5 years of useful life, which gives us a figure of 16,000.



The amount of depreciation that would be included in the list of operating expenses for this particular asset would then be 16,000 per year for 5 years.

But how does that impact the balance sheet? The asset is brought onto the balance sheet at its cost of acquisition, in our example that’s 100,000.

The amount of depreciation calculated for each financial year and included as an operating expense in the income statement is then deducted from that initial value to arrive at the asset’s net book value.

Let’s assume for the sake of simplicity that our example business acquired its asset on the first day of its financial year.

At the end of that period, the amount of depreciation is 16,000 so the net book value of the asset is the initial cost of 100,000 less accumulated depreciation of 16,000…..

….which, in this case, is only for the first year. This gives us a net book value of the asset on the balance sheet of 84,000.

In the following financial year's balance sheet the net book value of the asset changes since another year's depreciation has been included in that year's operating expenses.

Now the figure in the balance sheet will be the initial cost of 100,000 less accumulated depreciation of 32,000, which represents two full years' depreciation. Then the net book value on the balance sheet will be 68,000.

That same process continues each financial year for the useful life of the asset or until it is disposed of.

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