

DEPRECIATION ACCOUNTING -EMERGING PERSPECTIVES

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Though it is banal over-simplification to state that a physical asset in the process of use does wear out, at least to the extent of making its continued use uneconomical, it is also conceded that the services rendered by a physical asset tend to get exhausted with its continued use. This underlines the fact that depreciation is both a physical and an economic phenomenon—the latter may be correlative with the former but may sometimes be independent of it—and the distinction between these two facets accounts for the difficulty in a wider understanding as well as a proper appreciation of the significance of depreciation in accounts. Consequently, misconceptions and misunderstanding about depreciation are proliferating fast despite the fact that the subject is of universal importance.

Depreciation is simply plant cost or value) in the absorbed or expired stage; the periodic depreciation charge is a part, in monetary terms, of the package of plant facilities employed in business operations. In a way, depreciation is plant facility consumed and the slice consumed is of the same prosaic substance as the rest of the loaf. According to the Institute of Chartered Accountants of England and Wales:

“Depreciation represents that part of the cost of fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent on the amount of profit earned”.

This depreciation is a slow, graduated and unobtrusive process rather than sudden and bizarre: it is an actual and explicit cost rather than a phoney, assumed or hypothetical charge; it is certainly not an optional or borderline cost. There is nothing imaginary about plant facilities, which cannot be dispensed with in carrying on business operations, with the consequence that the cost of such facilities cannot reasonably be ignored, or put in a subordinate position, in the computation of income.

Depreciation accounting, from the financial accounting point of view, is concerned with the allocation of the cost of an asset over its useful life and charges the revenues of a period with the expenses of earning those revenues. The following description of depreciation accounting from the Terminology Bulletin of the American Institute of Certified Public Accountants has gained wide popularity:

“Depreciation accounting as a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation and not of valuation”.

Depreciation accounting, in this way, is authoritatively visualized as an exercise in the assignment of plant cost to the revenues of the particular year or other accounting period, the valuation concept thereby getting a short shrift.

Though there is nothing fixed or inevitable about the objects of depreciation policy, which are essentially a matter of choice, a possible objective might be to recapture from period revenue an adequate number of monetary units either to provide for the replacement of the asset on retirement or, alternatively, to recover the original investment (i. e. acquisition cost), the former resulting in the maintenance of the long-run money value of an originally acquired asset or series of assets. Another feasible objective is that of reflecting in the amortization charge for any given period the share of the total asset service potential that has expired during the period – a concept which does not necessarily appear to be in conflict with the recapture thesis and purports to be descriptive of the economic events.

An alternative aim of far wider significance, which would at the same time achieve the first two objectives also, might be to greatly enhance, an undertaking's money value or revenue – earning capacity over a period of year by 'ploughing back' profits through savings and investments a conspicuous feature of, many small proprietary businesses developing into giant enterprises. A fourth course may be to make no attempt either to maintain fully, or to enhance an asset's or undertaking's value and to distribute net earnings without making little or no provision for the future.

Ordinarily, depreciation accounting is designed, to recover simply the number of monetary units originally committed to the asset irrespective of differences in their purchasing power. This is quite satisfactory in periods of relative price stability but can be seriously, and even ruinously inadequate during period of relentless inflationary pressures with sharp drop in the purchasing power of the monetary unit. The point has been forcefully emphasised by Mr. J. R. D. Tata, chairman of Tata Iron and Steel Company Limited in his statement for 1971-72 at the annual general meeting of the Company.

“...By a healthy and productive plant we mean one maintained at a peak of efficiency by continuously replacing worn out or obsolete parts and incorporating improvements in equipment, processes and techniques as they become available. All this costs far more money that available from allocations to depreciation in view of the enormous increase in the cost of new equipment over the historical cost of the equipment it replaces”

Therefore in order to perpetuate a given amount of physical capacity from one mechanical generation to another regardless of its value, the ideal objective of depreciation is considered to be the recovery each year of a sufficient number of current monetary units to equal that year's capital consumption in terms of original monetary units and any failure to adopt such a course is bound to result in a wholesale dissipation of real capital with dire consequences to an enterprise and the entire economy during period of extreme inflation.

This replacement viewpoint regarding depreciation is rooted in the long range role of a business enterprise, which is visualised as that of an income generation motor that has to be continually recharged by replacement of old and worn out fixed assets acquired in an inflationary market at substantially higher prices than those at which they were originally installed, rendering the provision for depreciation on the basis of historical cost woefully inadequate in relation to real capital consumption. In its inimitable style, 'Economist' of London has rightly observed "accountants are expected to ignore inflation but inflation does not ignore the accounts; it makes a mockery of them".

The increasing realisation that, to maintain the capital of a business in these days in terms of capacity to produce goods and render services, a sufficiently larger number of monetary units have to be earmarked out of the revenues of the business than amount charged to depreciation based on the original cost or such capacity in the form of buildings and equipment, has generally created an illusion that the process of depreciation accounting—accruing depreciation—automatically provides funds for replacement and all that is necessary to obtain more money is to accrue more, depreciation.

However, it is none of the objectives of depreciation accounting to provide funds for replacement and the charge for depreciation neither increases nor decreases the amount available to purchase new equipment making charges to income and setting up reserves for depreciation give no assurance of funds for replacement while funds set aside for replacement will be available for that purpose whether charges have been made to depreciation or not.

Fund utilisation is a fairly complex process and its details will vary with changing conditions and changing managerial attitudes. Receipts from customers on the delivery of product at a price are used to pay current accounts as they fall due including pay roll, taxes, etc, to pay interest on loans to repay long-term debt or redeem preference shares, to expand inventories, to acquire additional plant facilities or other non-current resources, to pay dividends as well as to build up cash backlog and, in this over all process it is seldom if even that the amount of depreciation accrued during the year is decisive factor in moulding decisions as to particular expenditures so that the increase in total cash balance does not in any way show a close relationship to the current depreciation charge. As a matter of fact, in a sound enterprise, the additional funds required for replacement must come from retained earnings, temporarily supplemented in times of peak expenditure by borrowings and therefore, the relationship between depreciation accounting, as well as the timing and financing of replacements, is by no means as close as is commonly understood.

Further, at variance with the common impression, depreciation policy has nothing to do with subsequent expenditure or reinvestment of funds recovered with the consequence that, if a lathe is being depreciated the charge is properly the same regardless of whether the funds are spent for another lathe, a milling machine, a refrigerator or a typewriter and it would be the same for an enterprise under liquidation with no reinvestment as it is for a growing concern. This is due to the reason that depreciation accruals are rarely, if ever, earmarked for exactly the same items or types of

items that generate them and go into the same pot for re-investment irrespective of their being related to particular assets.

Systematic recognition of depreciation is necessary as a vital step in the process of compiling the costs assignable to revenue and determining the magnitude of periodic net earnings in accordance with the fundamental principle of matching cost against revenue, while the technical accounting for depreciation, in the strict sense, is in no way affected by the possibility of replacement or the conditions of replacement except to the extent that such factors may modify service life of property in use, so much so that this would hold good even in the case of depreciating property which would certainly not be replaced. Thus, where a mining shaft is constructed for exploiting a mineral deposit to be exhausted at the planned rate of extraction, it would be necessary to recognise the depreciation of shaft periodically in the determination of total operating cost notwithstanding the fact that the asset being depreciated will never be replaced and the accounting procedure will in no way be changed by the fact that no replacement is called for. From this point of view, depreciation accounting is primarily concerned with the measurement of income rather than with the provision of funds for replacement.

Nevertheless, in order to have a more meaningful application of the principle of matching costs to revenue and to arrive at a more realistic figure of profit, it is necessary that the current flow of revenue from customers should be sufficient to cover the current cost of labour and other services, the current cost of materials consumed, the current cost of plant capacity consumed as well taxes and other charges to leave a capital attracting for the share holders. This test of long-range successful operation can be satisfied by an enterprise if it provides depreciation on fixed assets keeping in view the necessity of plant renewal and the level of replacement cost, which is very important in planning property utilisation, making departmental comparisons, pricing policies, determining insurable value setting up maintenance standards, etc. requiring that the data of replacement cost be made continuously available as a basis for well, administrative decisions.

Quite contrary to the general illusion, the replacement cost is not the estimated cost of replacing the assets at the end of its estimated service life, perhaps many years in future, because it is hardly worth-while even to attempt to guess the amount that may be required to be spent on the replacement of an asset say ten years, hence; all that is expected is the current level of plant cost required to carry on production because as is usually pointed out, the significant point is 'as to what it would cost currently to acquire a fixed asset and this information alone is useful to management in decision making.

Once it is conceded that capital is to be considered as having been fully recovered only when the recovery is equal to the original investment in terms of purchasing power an adjustment of depreciation deduction to compensate for the shrunken monetary unit appears a matter of simple justice with an overriding economic rationale, from the point of view of the, tax-payer inasmuch as a larger depreciation allowance would increase the volume of funds for renovation and expansion of productive facilities thereby resulting in a salutary stimulus to productivity. Some people have gone to the length of suggesting that much of the demand for linking provision of depreciation to changes in price level springs from a deep-seated desire. to reduce taxes and. if there were no tax reductions to

be hoped for from such a linkage, the move for the recognition of special allowance to the owners of depreciable productive facilities would lose much of its force.

However, as the assumption of the monetary unit representing the same magnitude at different periods of time is deeply imbedded in tax policy and practice, the present system of taxation would always find it difficult to come to terms with the adjustment of depreciation charges according to changes in the purchasing power of the monetary unit in the work of inflationary pressures which would, in fact, necessitate the designing of the system de novo. Despite the fact that a number of countries have formulated schemes to adjust depreciation to a limited extent for fluctuations in the value of the monetary unit due to weighty economic considerations. Governments officially do not prefer to recognize inflation for the fear of building it into people's habits and so accelerating it.

While taxes are levied as percentage of apparent profits, accounts prepared on the basis' of changing price level would reveal to the charging of all concerned that the burden of taxation on real profits is a materially higher percentage and pressures would be mounted for liberal depreciation allowances for taxation purposes. On the other hand, any allowance in favour of an adjusted cost in computing depreciation for tax purposes will provide useful grist to the propoganda mill of a demagogic politician who would then be able to impress the gullible public with the specious argument that, when other sections of society are groaning under the crushing burden of taxation, business alone has been singled out for the favour of being bestowed with the privilege of making use of a novel method in calculating its taxable profits.