



PURPOSE OF CHARGING DEPRECIATION: AN INDIAN PERSPECTIVE

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ABSTRACT

Purpose of charging depreciation is an important consideration for providing depreciation. The present study has tried to find out the views of corporate sector regarding the purposes of charging depreciation. For this following purposes of providing the depreciation viz. Proper valuation of fixed assets, Proper allocation of cost for fair measurement of cost of production, Fair measurement of profits or losses, Financing the replacements of fixed assets, Financing the working capital needs, Having the advantage of tax relief have been considered and respondents from industry were requested to opine.

Key words: Depreciation, purpose of charging depreciation, valuation of assets.

Introduction

A number of authors have defined depreciation. Following are some of the definitions of depreciation.

Macfarland and **Ayars** explain depreciation as an expense arising out of the continuous lessening in the value of fixed assets caused chiefly by wear and tear, the effect of elements and gradual obsolescence.

Horngren defines depreciation as, "The allocation of original cost of plant, property and equipment to the particular period or products that benefit from the utilization of the assets."

Batliboi states, "Depreciation represents the loss or diminution in the value of an asset consequent upon wear and tear, obsolescence, effluxion of time, or fall in the market value."

In the views of **Mukherji and Sengupta** , " Depreciation is often characterized a diminution of value. The common sense view also relies on this idea. The concept implies that depreciation is the reduction in value of a fixed asset by physical wear and tear, obsolescence or passage of time."

In the words of **Carter**, "Depreciation is the gradual and permanent decrease in the value of an asset from any cause."

Review of Literature

Goldberg (1955) conducted a research regarding treatment of depreciation of fixed assets of 78 trading companies in Australia covering a period from 1945-54. He found that some companies consistently charged depreciation and other did not. Some companies were using disclosure practice and other do not, some were considering depreciation charge as a means of providing for replacement of asset while other using it for cost allocation only.

In late sixties **Krishnaswamy's (1969)** contribution may be considered as landmark contribution. In an article "Concept of Depreciation -- An Analysis ", he tried to depict the viewpoints of various persons (from different fields) like Economists, Accountants, Industrialists and legal regarding depreciation. He summarized the whole position as follows:

- (a) Depreciation representing the use of capital fund represented by the plant to be charged to the cost of production to match the revenue is an economic concept and does not take into account the depreciation arising due to passage of time and obsolescence.
- (b) The accountant's concept of depreciation is midway between that of economist's view i.e it is a cost of production as well as represents the diminution in the value of an asset due to passage of time and obsolescence.
- (c) Because of difficulty of measuring the exact quantum of depreciation, a rule of thumb method has been adopted by accountants in estimating the depreciation by dividing the cost of the asset by the estimated useful life of the asset and hence the accountant's depreciation does not amount to a quantified amount of actual depreciation existing or accrued during the life time of the asset.

- (d) The accountant's depreciation should be charged on systematic, rational and logical basis, which should not be changed unless warranted by changes in facts or circumstances or the rationale behind the basis originally adopted.
- (e) As per industrialist's views he suggested that depreciation as such is not a source of funds for replacement of assets but rather the revenue earned is. Without providing for depreciation, funds could be earmarked out of surplus for replacement of plant.

He further suggested that if necessary, new concepts in line with modern development in science and technology could be developed with regard to depreciation.

Ebling (1987) in an article "A Better Appreciation of Depreciation" considered the different views on the purpose of providing depreciation. The author depicted 'the purpose(s) of providing depreciation was/were:

- I. to provide for the future replacement of assets;
- II. to reflect the loss of the value of fixed asset during its life; and
- III. to allocate cost against revenues.

The author further commented on the revised SSAP 12 "Accounting for Depreciation."

Dunn (2005) in an article "Depreciation - Methods of Accounting" looked at three methods of depreciation viz. Straight line method, Written down value method and sum of years' digits methods along with the factors of providing depreciation in the light of FRS 15 in detail with examples.

Objectives of study

Following are the main objectives of study:

- To study industry wise and sector wise opinion of respondents from corporate sector regarding purpose of charging of depreciation.
- To examine sector wise comments of from corporate sector officials regarding purpose of charging of depreciation

Sample size and Data

A sample of 61 respondents from various industries and sectors has been taken to conduct the study. Primary data has been gathered by way of getting questionnaires filled. For theory part various books, journals etc. have been consulted and different websites have been visited.

Hypotheses of Study

For the purpose questionnaire has been sent for opinion survey and following null hypothesis has been formulated and tested.

Ho- 1: There is no significant difference of opinion amongst companies regarding purposes of charging depreciation across industries and between sectors.

Statistical Technique(s) used

Chi square Test has been used to establish the results statically.

Study

Purpose(s) of Charging Depreciation

For the researcher it has been a matter of interest to explore the purposes for which the companies under study are charging depreciation. Further it has also been studied if there is any difference in the purpose of charging depreciation industry wise as well as sector wise.

For the purpose the respondents are asked whether the following purposes have inspired them to charge depreciation:

- a) Proper valuation of fixed assets
- b) Proper allocation of cost for fair measurement of cost of production.
- c) Fair measurement of profits or losses.
- d) Financing the replacements of fixed assets.
- e) Financing the working capital needs.
- f) Having the advantage of tax relief.

Table 1 provides the view point of respondents from Indian corporate sector that all purposes except the purpose of financing working capital needs are the main purposes of charging depreciation. The results of chi-square test in Table 1 indicate that the respondents from corporate sector in India do not significantly differ. After examination, whatever information collected from the respondents from sample entities, has been presented industry wise as well as sector-wise in the tables 2 and 3 respectively. The obtained and critical values of chi-square are also there in the tables. From industry to industry, with respect to the purposes of charging depreciation, the percentage distribution of responses in the table also supports the same. As per the majority of the respondents in each case, depreciation is being mainly charged for (a) "Proper valuation of fixed assets", (b) "Proper allocation of cost for fair measurement of cost of production", (c) "Fair measurement of profits or losses, (d) Financing the replacements of fixed assets" and (f) "Having the advantage of tax relief"

purposes in each industry. However in case of purpose (e) i.e. "financing the working capital needs", different information emerges from the same table. In this case most of the respondents from chemical, electronics and engineering and diversified and others industries reported that this purpose has not motivated them to charge depreciation but in case of steel and textiles industries the response is equal in favour and against(Table 2).

As far as the sector wise comparisons are concerned in case of all of the purposes there has been a non-significant difference in opinions between the respondents in the two sectors (Table 3). The majority of the respondents in both the sectors have considered a) "Proper valuation of fixed assets," b) "Proper allocation of cost for fair measurement of cost of production," c) "Fair measurement of profits or losses", d) "Financing the replacements of fixed assets" and f) "Having the advantage of tax relief" purposes while charging depreciation whereas majority of the respondents said that the purpose e) "Financing the working capital needs" do not inspired them to charge depreciation.

On the whole, one basic fact emerging out of the above tables is that the purposes a) "Proper valuation of fixed assets", b) "Proper allocation of cost for fair measurement of cost of production", c) "Fair measurement of profits or losses", d) "Financing the replacements of fixed assets" and f) "Having the advantage of tax relief", are the mostly favored purpose of charging depreciation as compared to purpose e) "Financing the working capital needs" when considered industry wise as well as sector wise.

Findings

- Regarding purpose of charging depreciation majority of the respondents from all industries have stated that depreciation is being mainly charged for a) "Proper valuation of fixed assets", b) "Proper allocation of cost for fair measurement of cost of production", c) "Fair measurement of profits or losses, d) Financing the replacements of fixed assets" and f) "Having the advantage of tax relief".
- However in case of purpose e) i.e. "Financing the working capital needs", most of the respondents from chemical, electronics and engineering and diversified and others industries reported that this purpose has not motivate them to charge depreciation but in case of steel and textiles industries the response has been equal in favour and against.
- The purposes a) "Proper valuation of fixed assets", b) "Proper allocation of cost for fair measurement of cost of production", c) " Fair measurement of profits or losses", d) "Financing the replacements of fixed assets" and f) "Having the advantage of tax relief", as compared to purpose e) "Financing the working capital needs" have been the mostly

favoured purposes of charging depreciation considered industry wise as well as sector wise.

- For all respondents from industries and sectors included in the study, factor (c) "Requirements of Company law" is the major guiding factor of depreciation policy. Next in importance is, factor (b) "On recommendations and guidance of professionals" and factor (a) "Customary and traditional practice" is of least importance.

TABLE 1

Purpose(s) of Charging Depreciation

Purpose	Yes	No
a) Proper valuation of fixed assets	50(81.97)	11(18.03)
b) Proper allocation of cost for fair measurement of cost of production.	54(88.52)	7(11.48)
c) Fair measurement of profits or losses.	57(93.44)	4(6.56)
d) Financing the replacements of fixed assets.	47(77.05)	14(22.95)
e) Financing the working capital needs.	16(26.23)	45(73.77)
f) Having the advantage of tax relief.	43(70.49)	18(29.51)

Source: Compiled from Questionnaire

Table 2

Industry wise Analysis of Purpose(s) of Charging Depreciation by Corporate Sector in India

Purpose(s) of charging depreciation	Events	INDUSTRIES					Total	Value of Chi Square at 0.05 level of significance		Hypothesis Accepted or Rejected
		Chemicals	Electronics & Engineering	Steel	Textiles	Diversified & Others		Obtained	Critical for 4 degree of freedom	
a) Proper evaluation of fixed Assets	YES	15(83.33)	15(83.33)	3(75)	3(75)	14(82.35)	50	0.3099	9.49	Accepted
	NO	3(16.67)	3(16.67)	1(25)	1(25)	3(17.65)	11			
b) Proper Allocation of cost	YES	17(94.44)	14(77.77)	4(100)	4(100)	15(88.24)	54	3.7058	9.49	Accepted
	NO	1(5.56)	4(22.23)	0(0)	0(0)	2(11.76)	7			
c) Fair measurement of Profits	YES	18(100)	16(88.88)	3(75)	3(75)	17(100)	57	7.5061	9.49	Accepted
	NO	0(0)	2(11.12)	1(25)	1(25)	0(0)	4			

d) Financing the replacement of fixed assets	YES	12(66.67)	15(83.33)	3(75)	4(100)	13(76.47)	47	2.7034	9.49	Accepted
	NO	6(33.33)	3(16.67)	1(25)	0(0)	4(23.53)	14			
e) Financing the Working capital needs	YES	6(33.33)	4(22.23)	2(50)	2(50)	2(11.71)	16	4.7932	9.49	Accepted
	NO	12(66.67)	14(77.77)	2(50)	2(50)	15(88.29)	45			
f) Having advantage of tax relief	YES	13(72.22)	9(50)	4(100)	4(100)	13(76.47)	43	7.3006	9.49	Accepted
	NO	5(27.78)	9(50)	0(0)	0(0)	4(23.53)	18			

Source: Compiled from Questionnaire

TABLE 3

Sector Wise Analysis of Purpose of Charging Depreciation by Corporate Sector in India

Purpose of charging depreciation	Events	SECTOR			TOTAL	Value of Chi Square at 0.05 level of significance		
		Public	Private			Obtained	Critical for 1 degree of freedom	Hypothesis Accepted or Rejected
			Foreign Subsidiaries	Indian (domestic companies)				
a) Proper evaluation of fixed Assets	YES	5(83.33)	9(75)	36(83.72)	50(81.97)	0.0084	3.84	Accepted
	NO	1(16.67)	3(25)	7(16.28)	11(18.03)			
b) Proper Allocation of cost	YES	5(83.33)	11(91.67)	38(88.37)	54(88.52)	0.1765	3.84	Accepted
	NO	1(16.67)	1(8.33)	5(11.63)	7(11.48)			
c) Fair measurement of Profits	YES	5(83.33)	12(100)	40(93.02)	57(93.44)	0.6344	3.84	Accepted
	NO	1(16.67)	0(0)	3(6.98)	4(6.56)			
d) Financing the replacement of fixed assets	YES	4(66.67)	8(66.67)	35(81.40)	47(77.05)	0.4457	3.84	Accepted
	NO	2(33.33)	4(33.33)	8(18.60)	14(22.95)			
e) Financing the Working capital needs	YES	2(33.33)	3(25)	11(25.58)	16(26.23)	0.1736	3.84	Accepted
	NO	4(66.67)	9(75)	32(74.42)	45(73.77)			
f) Having advantage of tax relief	YES	4(66.67)	9(75)	30(69.77)	43(70.49)	0.0468	3.84	Accepted
	NO	2(33.33)	3(25)	13(30.23)	18(29.51)			

Source: Compiled from Questionnaire

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