

## **GUIDING FACTORS FOR DEPRECIATION POLICIES: A VIEWPOINT OF INDIAN INDUSTRY**

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### **Abstract**

Depreciation policy is being affected by different factors. The presents study considers the factors viz. Customary and traditional practice, on recommendations and guidance of professionals and as per company law as guiding factors for adopting depreciation policy by corporate sector in India. A survey has been conducted to find the guiding factors for industry in India and relationship of these factors industry as well as sector wise.

Key words: Depreciation, Guiding factors for depreciation policies, methods of depreciation.

### **Introduction**

In the views of **Sidney Davidson and Schindler**, "The central purpose of the depreciation accounting process is to allocate the cost of these assets to the periods of their use in a reasonable and orderly fashion."

According to **Bierman**, "The accepted function of depreciation accounting from the financial accounting point of view is to allocate the cost of an asset over its useful life and charge the revenue of a period with the expenses of earning those revenues. We must determine how much of the cost of the investment should be allocated to each period. "

**Montgomery** says," Depreciation is an allocation of entire cost of depreciable assets to the operating expenses of series of fiscal periods. Physical depreciation of property, plant and equipment is generally understood to be the loss in useful life or efficiency caused by wear and tear from operation and by deterioration resulting from chemical reactions from air, water, gas or other elements. In varying degrees it takes place whether plant and equipment is operating or idle, whether it is well cared for or neglected, whether it is built from materials of good quality or constructed from scrap."

**Himmelblau** opines," Depreciation accounting is the process of spreading the value of a fixed asset over the accounting periods comprising its service life."

**Roy** observes, "Depreciation is a process of allocation as well as valuation."

## **Review of Literature**

Daniels (1933) in an article “The valuation of fixed assets “considered three main aspects for the valuation of assets viz. (1) Value of assets from equities i.e. the stock exchange quotations provides the current value of stocks and bonds according to this the total value of stocks in hand of the public plus the value of the bonds and the outsider liabilities would provide the value of the corporation. (2) The second possible approach to value assets might be the capitalisation of earning and (3) the third one was the appraisal of the assets. The author further explained the function of depreciation as the provisions of the means for equitable distribution of the cost of comparatively long lived assets however the method used for providing depreciation was unimportant. He also considered the overcharging of depreciation under the cap of depreciation reserves and even cited the example of a company which had practically misused this concept. Finally he suggested the cost as the relevant basis for valuation of assets.

**Grady** (1950) in a Paper published in “The Accounting Review “ under the heading “ Accounting for Fixed Assets and their Amortisation “, suggested the following:

- 1) Where depreciation reserve was materially out of line as required in relation to age and life of the properties, one must make appropriate to the reserves by charging or crediting surplus.
- 2) Provisions for amortisation of depreciable tangible fixed assets must be made regularly covering the historical cost and the excess of current dollar costs over the historical cost.
- 3) The condition of the depreciable properties must be studied regularly e.g every five years in order to revise the annual amortisation, if necessary, in the light of the current estimates of the remaining useful lives of the properties.
- 4) Production method of amortisation might be adopted if the business enterprise is subject to the important variations in the volume of the business.

**Dobrovolsky** (1951) in early fifties considered the relationship between depreciation and investment policies. The paper “Depreciation Policy and Investment Decisions”, attempted to examine some basic relationships between the depreciation method and the net income derived from investment in durable equipment, under different business conditions and different Income tax provisions.

**Dixon** (1960) in early sixties observed that the sum of years’ digits and declining balance methods, now so widely used for tax purposes, might fortuitously approximate real depreciation under certain circumstances, but it would be preferable to develop declining charge curves in which proper allowances for the factors of interest and service deterioration had been made.

**Messere and Zuckerman** (1981) in a paper “ An Alternative Approach to Depreciation Switches”, provided a general mathematical procedure of when to switch from a declining-balance method to the straight-line method. This decision model covered situations both with and without 1) salvage value, 2) bonus first year depreciation, 3) the salvage value reduction of Internal Revenue Service and 4) proportionate first year depreciation. Additionally this model could be used to determine when a switch would not occur.

**Anand** (2002) in an article “Diverse Roads to Depreciation”, considered the gap between book depreciation and tax depreciation. He welcomed the introduction of AS-22 “Accounting for Taxes on Income”. He further considered the version of other people who were of the view that the problem of profit gap was still being addressed in circuitous way. The permanent solution suggested was to have common depreciation rates for all statutes and all purposes.

### **Objectives of study**

Following are the main objectives of study:

- To study industry wise and sector wise opinion of respondents from corporate sector regarding opinion regarding factors guiding depreciation policy
- To examine sector wise comments of from corporate sector officials regarding opinion regarding factors guiding depreciation policy

### **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 the following null hypothesis has been formulated and tested:

Ho-1: There is no significant difference of opinion regarding factors guiding depreciation policy, amongst the respondents both across the industries as well as between the sectors

### **Statistical Technique(s) used**

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

### **Study**

#### **Factors Guiding over all Policies of Depreciation**

Under this efforts have been made to investigate the factors guiding the overall depreciation policies of sample companies from corporate sector in India. Overall depreciation policies include choice of depreciation methods, adoption of depreciation rates, review of useful life, revision of depreciation rates, change of depreciation method(s), revaluation policy, and inflation adjustments for depreciation, creation of sinking fund and treatment of unusual items like obsolescence, accidents and inadequacy. The above mentioned have been considered one by one individually but in this section it has been tried to study empirically the factors which have guided the overall depreciation policy. Further another matter of interest here is to examine the difference of opinions of the respondents (if any) regarding the factors guiding depreciation policy across the industries and between the sectors.

The respondents from the sample entities have been asked to give their opinion

whether the following factors guided their depreciation policy or not:

- a) Customary and traditional practice
- b) On recommendations and guidance of professionals
- c) As per company law.

Table 1 has been constructed to show the overall effect of factors listed above while deciding policy of depreciation. For further analysis Tables 2 and 3 have been built from the data collected. The data have been analyzed and interpreted in the light of above-mentioned tables in the following manner. The first striking fact emerging out from the responses is that all of the respondents replied positive in favour of the factor c) i.e. Requirements of Company law in case of all industries as well as both of the sectors. The second factor, which gathers favour is factor b) i.e. On recommendations and guidance of professionals whereas the factor a) i.e. Customary and traditional practice has been considered the lowest, favored guiding factor. Industry wise in case of chemical industry, factor (c) "Requirements of Company law" is considered by all respondents, while an equal percentage of them have considered the other two factors (a) "Customary and traditional practice" and (b) "On recommendations and guidance of professionals". Further factor (b) "On recommendations and guidance of professionals" has been considered at second place by electronics and engineering and steel industries whereas textile industry considered factor (a) "Customary and traditional practice" at second place. Then in case of sector wise consideration both public as well as private sector factor (c) "Requirements of company law" has drawn proper consideration from all respondents and factor (a) "Customary and traditional practice" from a higher percentage in case of public sector companies and factor (b) "On recommendations and guidance of professionals" got higher percentage from private sector respondents as compared to factor (a) "Customary and traditional practice".

On the basis of above, one might interpret that 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" has been of least importance.

The chi square test results show that there is no significant difference of opinion amongst the respondents as regards to consideration of each of the factors guiding depreciation policy, both across the industries and between the sectors.

## **Findings**

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. From the above we can conclude that companies are not following depreciation policy merely on customary practices they firstly get the guidance from the company Act's provisions and then follow other factors.

**TABLE 1**

**Factors Guiding Policy of Depreciation**

Event→ Factor↓	YES	NO
a) Customary and traditional practice	20(32.79)	41(67.21)
b) On recommendations and guidance of professionals	24(39.34)	37(60.66)
c) As per company law.	61(100)	0(0)

Source: Compiled from Questionnaire

**TABLE 2**

**Industry wise Analysis of Factors Guiding Policy of Depreciation**

Factors guiding policy of depreciation	Event	INDUSTRIES					TOTAL	Value of Chi Square at 0.05 level of significance		
		Chemical	Electronic & Engineering	Steel	Textiles	Diversified & Others		Obtained	Critical for 4degree of freedom	Hypothesis Accepted Or Rejected
Customary and traditional practice	YES	5(27.8)	6(33.33)	1(25)	3(75)	5(29.41)	20(32.79)	3.6398	9.49	Accepted
	NO	13(72.12)	12(66.67)	3(75)	1(25)	12(70.59)	41(67.21)			
On recommendations and guidance of professionals	YES	5(27.78)	9(50)	2(50)	1(33.33)	7(41.18)	24(39.34)	2.4246	9.49	Accepted
	NO	13(72.22)	9(50)	2(50)	3(66.67)	10(58.82)	37(60.66)			
As per company law	YES	18(100)	18(100)	4(100)	4(100)	17(100)	61(100)	--	--	---
	NO	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)			

Source: Compiled from Questionnaire

**TABLE 3**

**Sector wise Analysis of Factors Guiding Policy of Depreciation**

Factors guiding policy of depreciation	Events	SECTOR				TOTAL	Value of Chi Square at 0.05 level of significance		Hypothesis Accepted or Rejected
		Public	PRIVATE				Obtained	Critical for 1 degree of freedom	
			Foreign subsidies	Indian	Total				
Customary and traditional practice	YES	3(50)	2(16.67)	15(34.88)	17(30.91)	20(32.79)	0.8947	3.84	Accepted
	NO	3(50)	10(83.33)	28(65.12)	38(69.09)	41(67.21)			
On recommendations and guidance of Professionals	YES	1(16.67)	2(16.67)	21(48.83)	23(41.82)	24(39.34)	1.4340	3.84	Accepted
	NO	5(83.33)	10(83.33)	22(51.17)	32(58.18)	37(60.66)			
As per Company Law	YES	6(100)	12(100)	43(100)	55(100)	61(100)	--	--	----
	NO	0(0)	0(0)	0(0)	0(0)	0(0)			

Source: Compiled from Questionnaire

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