Depreciation doublespeak

By Alan J Robb

George Orwell popularised doublethink and doublespeak in his novel Nineteen Eighty-four. Doublethink means the power to hold two contradictory beliefs in one’s mind simultaneously and accept both of them. Doublespeak involves the ability to speak or write two or more contradictory ideas without the speaker or writer being aware of the contradiction.

Some would say that the accounting profession has raised this to an art form in some of its accounting standards and public comments, both in New Zealand and elsewhere.

Accounting reports are of good quality when the information presented is reliable, relevant, understandable and comparable. Information is reliable when it is neutral, verifiable and faithfully represents ‘actual underlying transactions and events.’

Doublespeak allows accounting standard setters to present contradictory ideas of what are actual underlying events. This is clearly seen in the way depreciation is dealt with in FRS3 Accounting for Property, Plant & Equipment.

To readers of financial reports depreciation means the fall in value of an asset. The FRS reinforces this understanding by urging that revaluations should occur annually “in order to provide more relevant information to users.” Revaluations are seen as a good way of showing the true value of assets.

But at the same time the FRS treats depreciation as an allocation of service potential consumed or used up. Depreciation must be written off as an expense whether or not an asset is falling in value. It must even be written off when the asset is increasing in value.

Accounting standard setters have got themselves into this doublethink situation by believing that the book value of an asset can simultaneously represent two different concepts - its physical service potential and its financial fair value.

The reason can be traced to American accounting practice of the 1960s. At that time the view was commonly held that a balance sheet was an historical document, “merely a list of balances at a specified point in time.” It did not purport to show the value of assets. In its ‘Inventory of Generally Accepted Accounting Principles for Business Enterprises’ compiled in 1965 the American Institute of Certified Public Accountants made the amazing statement that:

Definitions are unacceptable which imply that depreciation for the year is a measurement, expressed in monetary terms, of the physical deterioration within the year, or of the decline in monetary value within the year, or indeed, of anything that actually occurs within the year.

At that time depreciation was not anything that actually occurred; it was merely an allocation of historical costs.

Most accountants today believe that balance sheets should show assets at their fair value. If the fair value of an asset increases, the appreciation should be recognised. If the fair
value decreases, the depreciation should likewise be recognised. That is why the profession logically argues that assets should be revalued regularly, preferably annually.

But harking back to the illogical ideas of the 1960s FRS-3 asserts that depreciation “is not regarded as a measure of the decline in value of an item of property, plant or equipment.” In the convoluted language of the standard it is an allocation of “the measure of the consumption of economic benefits embodied in an asset”.

To those not blinded by doublespeak the faults of FRS3 are clear. The solution requires acceptance of the reality that depreciation should recognise the fall in fair value of fixed assets. If they have not fallen in value then they should not be depreciated. Only in this way can a true and fair view be given of financial position and financial performance.

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