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Terminology Department

American Institute of Accountants. Special Committee on Terminology

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Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON ACCOUNTING TERMINOLOGY
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The committee on terminology presents in this issue of THE JOURNAL OF ACCOUNTANCY definitions of:

Depreciation
Depletion
Amortization
Appreciation
Obsolescence
Inadequacy

The first thought of the committee was to publish definitions of these words by various authorities and at a later date to formulate its definitions based upon the consensus of opinion as reflected by the comments and criticisms received. This course would only delay final results and the committee therefore decided to formulate definitions at this time and, as far as possible, to establish definite lines of demarcation between the words discussed. These definitions are, of course, subject to revision and amplification after all communications on the subject have been duly considered.

Depreciation:

The basic idea conveyed by this word is indicated by its derivation—*de*, down, and *pretium*, price—that is, a reduction in price or value.

Depreciation is loss in physical or functional value of physical property other than wasting assets due primarily and chiefly to ordinary wear and tear which has occurred *theoretically* in the past and which is not offset by adequate repairs and/or replacements. Obsolescence and inadequacy are included by regulatory bodies and taxing authorities as contributory causes, but it is more in accordance with fact to treat these two elements as separate from ordinary wear and tear on the ground that the loss incident thereto does not usually accrue and cannot be foreseen with any degree of accuracy. Depreciation, however determined, is at best only an *estimate*.

Unfortunately for the possibility of clear accounting terminology, depreciation is also commonly used to denote shrinkage in the conversion value of property (securities, real estate, etc.) or mediums of exchange (coins, bullion or paper currency) and indicates in this sense a temporary or permanent loss arising from economic or related causes.

It is of interest that in some lines of business, e. g., long-distance telephone service, extraordinary casualties due to the action of the elements are regular visitants and are provided for by a so-called reserve for extraordinary depreciation which may be estimated in advance quite closely, based upon experience extending over a period of years.

Depletion:

Depletion conveys the idea of emptying, reducing or exhausting the source of supply and is used chiefly

(a) In reference to natural resources, such as mines or timber-lands, indicating loss in physical value properly commensurate with the removal of the product, and less frequently

(b) In reference to financial strength, as, for example, the "depletion of the treasury."

Depletion differs from physical depreciation in that the former implies the removal of an asset for consumption purposes, whereas the latter indicates a reduction in value caused by use or neglect.

The word is seldom found in the writings of British accountants, as is indicated by its omission from various word-books edited by Damson, Lisle, Pixley and Porter, and is usually interpreted by these writers in the sense of "expired capital outlay," forming one of the elements of depreciation.

Amortization:

The basic idea suggested by this word is that of reducing, redeeming or liquidating the amount of an account already in existence.

In finance and accounting this word means the gradual extinguishment of an asset, a liability or a nominal account by prorating the amount thereof over the period during which it will exist or during which its benefit will be realized.

Amortization is caused by, and the computations are based upon, efflux of time or units of production, the life of a right or obligation or the loss of possession or use being the governing factors, e. g., amortization of a patent or of debt discount and expense or of a bonus paid for a lease or of the value of machinery, buildings, etc., on leasehold property which revert to the landlord upon expiration of a lease, or of the value of mine equipment whose useful life is known to exceed the productive life of the mine and is necessarily to be abandoned upon ceasing operations.

Amortization is also used to denote the gradual extinguishment of a debt by means of a sinking fund.

The distinction between amortization and depreciation is clearly brought out in the case of a tributary asset such as mine shafting, where the life of the mine is estimated as less than that of the shafting. In such a case the shafting should be *amortized* over the life of the mine, and not *depreciated* on the basis of physical deterioration. If the mine product were no longer salable *obsolescence* would be the proper designation for the loss in value of the shafting.

In law, amortization has an additional meaning, namely, the act of alienating lands or tenements to a corporation in mortmain. In old French law this could only be done by permission of the king and there was involved the payment of a tax by the corporation so that in time the word was often used to signify this tax.

Appreciation:

This word indicates an increased conversion value of property (securities, real estate, etc.) or mediums of exchange (coins, bullion or paper currency) due to economic or related causes which may prove to be either temporary or permanent.

Appreciation is the antonym of depreciation in so far as the latter is used to denote shrinkage in conversion value.

Obsolescence:

The basic idea conveyed by this word is that of becoming out of date or falling into disuse.

It is usually applied to plant and equipment which although in good physical condition have become old fashioned through progress of invention or advance in the arts, results being achieved more efficiently and/or at less cost under new methods.

Obsolescence may also be caused by the cessation of a demand for the particular articles for the production of which a plant or unit thereof was constructed or installed. This element of loss would be eliminated if the plant or unit could readily be converted to other use.

Regulatory bodies and taxing authorities provide that obsolescence is to be considered in conjunction with wear and tear and inadequacy in arriving at depreciation rates, but in fact obsolescence, except in certain industries, rarely accrues and a plant unit is usually up-to-date until it actually becomes obsolete. Any provision for obsolescence is, therefore, in most cases, a mere segregation of surplus. Coming events occasionally but not usually cast shadows before.

Inadequacy:

The basic meaning of this word is lack of size or of capacity in its broadest sense.

The word usually refers to plant and equipment which, although in good physical condition, is inadequate to carry the productive load required of it. This element of loss would be eliminated if it were found practicable to continue the use of the old unit in conjunction with other units of like or larger capacity.

The element of accrual with respect to inadequacy is usually a matter of conjecture, but it can be better determined than with respect to obsolescence, the trend of business being the governing factor.

Regulatory bodies and taxing authorities provide that inadequacy is to be considered in conjunction with wear and tear and obsolescence in arriving at depreciation rates.

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