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# The Depreciation Impact of the Profit and Activity Development Carried out by an Economic Operator

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**Abstract:** It's interesting how an economic operator decides to depreciate its depreciable fixed assets, because depreciation is an expense input from the taxable profit in accordance with the laws in force, thus contributing to diminishing the operating profit/loss and implicitly the gross and net earnings, without real impact on profitability and especially without any impact on the self-funding capacity. But the impact given by the depreciation expenses may be influenced by the organization policy in the field of depreciation and by the fiscal laws.

**Keywords:** depreciable fixed assets, profit, loss, fiscal law

The following depreciation methods may be applied in Romania in order to determine the accounting depreciation:

- linear depreciation;
- degressive depreciation;
- accelerated depreciation.

Using one or another depreciation method, an additional deduction of the income tax is possible, thus increasing the net profit available for the economic operator, which, according to the resolution of General Shareholders' Meeting may be distributed mainly in the following two directions:

- for the payment of dividends due to the shareholders;
- for the organization development.

The bigger the expense input with the depreciation, the bigger the net profit - situation found when a faster depreciation policy is used. In other words, the effect of the degressive depreciation appears in choosing one of the depreciation methods used.

The difference between the depreciation methods is given by the value mentioned for the depreciation expenses in each depreciation year, thus:

- if the linear depreciation is used, the operating expenses are constantly influenced by the depreciation expenses;
- if the degressive depreciation is used, the depreciation expenses determined for each year are decreasing, the linear depreciation being used at a certain moment;

- if the accelerated depreciation is used, the operating expenses are greatly influenced in the first year of operation of the depreciable fixed assets and for the rest of the years of operation the depreciation expenses have a constant influence because the linear depreciation regime shall be used.

Therefore the impact given by the chosen method of depreciation appears when the income tax is determined, contributing to diminishing the taxable profit and implicitly the tax to be paid. When the income tax is determined the expense with the accounting depreciation is not taken into account\* .

For the fiscal depreciation, the depreciation methods stipulated in the Fiscal Code may be applied, specifying for each depreciable fixed asset the depreciation method that may be applied.

If the organization records profit, the tax economy is given by the product between the fiscal depreciation and the income tax rate. Since the income tax expense is an expense paid by the firm upon registration, thus generating a payment that diminishes the net earnings substantially, in determining the chosen depreciation method it is important to consider the value of money in time.

If the value of money in time is taken into account, the recommended fiscal depreciation method is the accelerated method, followed by the degressive depreciation method and then by the linear depreciation method. This may be explained as follows: by applying the accelerated depreciation method, an amount currently bigger is registered on input expenses, compared to the other depreciation methods.

In establishing the amount of the depreciation expenses, a great importance is held, besides the chosen depreciation method, by the life duration of the depreciable fixed assets owned, that is the number of years necessary to recover the value of the fixed assets by means of depreciation.

As from 2005 the economic operators can establish the number of years necessary to depreciate the depreciable fixed assets, but without exceeding the minimum and maximum life duration stipulated for each fixed asset in the "Catalogue regarding the classification and normal life duration of fixed assets", published in the Official Gazette no. 46/2005.

Thus, in order to obtain a fiscal economy as big as possible by the depreciation of depreciable fixed assets, whatever the chosen depreciation method, the choice of the minimum life duration is recommended.

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\* The accounting depreciation represents the expense paid when the depreciable fixed assets are purchased and it is not an expense paid by the economic operator when the depreciation is registered.

Similarly, due to the specific of the depreciation methods, the impact on the fiscal economy given by the depreciation according to the chosen duration of depreciation manifests itself at the highest level in the case of the linear depreciation method.

The amounts obtained by means of depreciation may be used to replace and develop the production potential of the economic operator.

Under economic stability, replacement and renewal of the production potential is relatively simple, as the value equivalent of the depreciation ensures the replacement of the depreciable fixed assets upon the expiry of the life duration established for each of them by the economic operator.

In the case of an inflationary economy, the issue of maintaining the production potential is more complex. Registering the fixed assets in accounting at the purchase price causes, in a period when the price of goods and services does not cease to grow, a reduction of value for the lasting goods owned by the economic operator.

An asset registered in accounting with an entry value under its renewal value does not provide enough cash to maintain the same production potential. Regarding the achievement of identical production goods, two issues are raised, that is: the issue of the technical progress that causes moral and the issue of the monetary degradation.

The technical progress makes it difficult to replace a good with another identical one, while from the point of view of monetary instability, the economic operator shall pay a bigger amount of money in order to obtain a good very much the same as the one it shall replace.

Under hyperinflation, the possibilities of the economic operator to ensure the replacement of the fixed assets used on account of the depreciations cumulated to the functioning ones are more and more reduced.

This aspect is partly attenuated by the fact that the fiscal duration of depreciation established by the legal regulation in force is more reduced than the economic life duration of the depreciable fixed assets, established by the economic operator with sensible reflection in the profitability of the fixed capital use.

Similarly, the inflation influence reduces even more in the case the accelerated method is used, through which it makes up some even greater financing sources and also benefits of an economy of the income tax, actually a postponement of its payment which shall be made in the future in the depreciated currency.

All the conclusions presented so far are based on the fact that the organization records profit and there are no changes of the income tax rate. If these conditions are not complied

with, the impact of the fiscal depreciation on the organization earnings must be analysed in each case, as follows:

- the increase of the fiscal economy given by the fiscal depreciation when the income tax rate is increased;
- the decrease of the fiscal economy given by the fiscal depreciation if a decrease of the income tax rate is recorded (for example when the income tax rate in Romania switched from 25% to 16%, there were advantaged the economic operators who used the accelerated depreciation for the depreciable fixed assets that started to operate in 2004);
- if the organization records fiscal loss, the fiscal economy given by the fiscal depreciation for a certain period or for the entire taxable year shall be determined as a product between the income tax rate and the positive difference between the value of the depreciation and the value of the loss. If the loss is bigger than the fiscal depreciation, there is no fiscal economy given by depreciation in that year. This loss may be recovered from possible profits registered in the following years, but the fiscal economy shall be diminished because of the loss of value in time.

In conclusion we may say that the accounting depreciation acts on the organization profitability within the meaning of the operating profit/loss and implicitly of the net earnings value and the fiscal depreciation causes the reduction of the income tax to be paid. The only one which influences the self-funding capacity is the fiscal depreciation, as it leads to the reduction of the income tax to be paid. The accounting depreciation does not influence the self-funding capacity, which may be seen in the formulas that underlie the self-funding capacity of an organization. Therefore in the deductive method the depreciation is not taken into account (the income tax that is influenced by the fiscal depreciation is taken into account) and in the additional method, even if the accounting depreciation is added to the net earnings, it was initially deducted from the gross operating surplus and therefore, the net earnings were reduced with its value.

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