

8. Service Life and Cost Allocation

Casually, people will speak of depreciation as a decline in value or using-up of an asset. However, in accounting jargon, the term is meant to refer to the allocation of an asset's cost to the accounting periods benefited -- not an attempt to value the asset. Thus, it is often said that depreciation is a process of "allocation" not "valuation." We have already addressed how an asset's cost is determined. Next, we must consider how to determine the accounting periods benefited (i.e., "service life").

Determining the service life of an asset is an essential first step in calculating the amount of depreciation attributable to a specific period. Several factors must be considered:

Physical deterioration -- "Wear and tear" will eventually cause most assets to simply wear out and become useless. Thus, physical deterioration serves to establish an outer limit on the service life of an asset.

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Sources: Keuzegids Master ranking 2013; Elsevier 'Beste Studies' ranking 2012; Financial Times Global Masters in Management ranking 2012

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Obsolescence -- The shortening of service life due to technological advances that cause an asset to become out of date and less desirable.

Inadequacy -- An economic determinant of service life which is relevant when an asset is no longer fast enough or large enough to fill the competitive and productive needs of a company.

Factors such as the above must be considered in determining the service life of a particular asset. In some cases, all three factors must be considered. In other cases, one factor alone may control the determination of service life. Importantly, you should observe that service life can be completely different from physical life. For example, how many computers have you owned, and why did you replace an old one? In all likelihood, its service life to you had been exhausted even though it was still physically functional.

Recognize that some assets have an indefinite (or permanent) life. One prominent example is land. Accordingly, it is not considered to be a depreciable asset.