

AS 6 – DEPRECIATION ACCOUNTING

Applicability

AS 6 though an old accounting standard is considered very significant, as it affects the preparation and presentation of financial statements for all enterprises. For the same reason, AS 6 is made applicable to all level of enterprises i.e. it applies in its entirety to level I, II, and III enterprises.

Issue 1 :

To which assets, AS 6 Depreciation Accounting is not applicable ?

☞ AS 6 applies to all depreciable assets except the following items to which special considerations apply–

- (i) forest, plantations and similar regenerative natural resources.
- (ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources.
- (iii) expenditure on research and development
- (iv) Good will
- (v) live stock
- (vi) Land, unless it has a limited useful life to the enterprise.

Issue 2 :

Which are the three factors usually considered in computation of depreciation and the amount to be charged in respect thereof in the accounting period ?

☞ Computation of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors :

- (i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued.
- (ii) expected useful life of the depreciable asset and
- (iii) estimated residual value of the depreciable asset.

Issue 3 :

Can there be any factors which determine whether useful life of an asset is shorter than its physical life?

☞ Under the following circumstances, useful life of a depreciable asset is shorter than its physical life and is :

- (i) Pre-determined by legal or contractual limits such as the expiry dates of related leases.
- (ii) Directly governed by extraction or consumption
- (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc. and
- (iv) reduced by obsolescence arising from such factors as :

- (a) technological changes
- (b) improvement in production methods
- (c) change in market demand for the product or service output of the asset or
- (d) legal or other restrictions.

Issue 4 :

Is depreciation required to be charged in each accounting period irrespective of the fact that the asset's market value has increased?

☞ Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of asset.

Thus, depreciation will have to be provided for each accounting year, irrespective of the fact that the market value of Fixed Assets has increased. For recognising market value of fixed assets, AS 10 permits revaluation of fixed assets.

Issue 5 :

A Ltd. engaged in production of steel, wants to provide for depreciation based on unit of production instead of straight line or written down value method. Can A Ltd. do so ?

☞ AS 6, on Depreciation accounting stipulates that minimum depreciation should be provided as made under statute i.e. the Companies Act, 1956. Schedule XIV to the Companies Act, 1956 prescribes various rates to be provided for different assets under straight line and written-down value method. However, where management estimates useful life of an asset shorter than as envisaged under the provisions of statute i.e. schedule XIV, then the depreciation is provided applying a higher rate.

Thus, if A Ltd. contemplates to provide depreciation on production basis and such depreciation happens to be lower than the depreciation worked out under schedule XIV, then A Ltd. would not be complying with the provisions of AS 6. Since, under the Indian Accounting Standard, reference is made to statute, companies in India will be required to provide minimum depreciation at the rates prescribed in schedule XIV. Based on the estimated useful life, if the depreciation rate is lower than the rate prescribed in Schedule XIV, companies will be required to approach central government in this regards.

Note : Under the International accounting standard or for that purpose US GAAP, depreciation is provided considering the best estimate of useful life of the asset. The following abstract from the financial statement of Cathay Pacific Airways will show that enterprise is at liberty to evaluate the estimate useful life of Fixed Asset.

Annual depreciation charges to write down the original cost of aircraft to estimated residual values are based on actual operational usage of the relevant aircraft as a proportion of its total estimated operational life. The useful operational life of an aircraft is determined by reference to its anticipated aircraft flight cycle while in service of the company. However, if the aircraft is held under a finance lease, the depreciable life of the aircraft is limited to the lease term unless a purchase option is held. A flight cycle is defined as one take-off and one landing. The residual value of aircraft and related equipment are 10% of original cost or values guaranteed under forward sales agreements.

Issue 6 :

R. Ltd. a newly incorporated company wants to provide depreciation on Plant and Machinery on straight line method whereas written down value method for the remaining fixed assets? Can R Ltd. do so ?

- ☞ Depreciation method is selected based on various important factors e.g. (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business.

AS 6, mentions, a combination of more than one method is some times used, meaning thereby that for few fixed assets straight line method can be adopted whereas for other fixed assets written down value method can also be adopted.

Accordingly R Ltd. can choose straight line method for plant and machinery and written down value method for other fixed assets.

Issue 7 :

P Ltd. is providing depreciation on straight line method. Due to technical evaluation, the estimated useful life of certain fixed assets is less as compared to life of assets as indicated by rates prescribed in schedule XIV of the Companies Act, 1956. Is P Ltd. required to provide depreciation considering the estimated useful life of asset which is higher than the rates prescribed in schedule XIV of the Companies Act, 1956. Is P Ltd. required to recompute depreciation from inception i.e. from the date when such fixed assets were purchased?

- ☞ AS 6 Stipulates that where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute i.e. Schedule XIV, the depreciation provision is appropriately computed by applying a higher rate. Hence, P Ltd. will be required to provide depreciation at higher rates than rates prescribed in schedule XIV.

Second and important issue that arises, how P Ltd. should compute the depreciation ? Since, this gives rise to a change in estimate and not a change in method, enhanced depreciation should be provided prospectively i.e. over the remaining useful life of the asset.

P. Ltd. will have to provide enhanced depreciation over the residual useful life of the asset.

Issue 8 :

P Ltd. was providing depreciation on Plant and Machinery on written down value method. With effect from 1-4-03, in respect of additions to, plant and machinery, P Ltd. wants to provide depreciation on straight line method, whereas for plant and machinery upto 31-3-03, it will continue to provide depreciation on written down value method. Is contention of P. Ltd. justified ?

- ☞ As per AS 6, the method of depreciation is applied consistently to provide comparability of the results of the operation of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use.

Accordingly, P Ltd. would not be justified in providing depreciation on straight line method in respect of additions to plant and machinery with effect from 1-4-03. P Ltd. can change method of providing depreciation from written down value to straight line method and this in compliance to Accounting Standard has to be done retrospectively from the date of the asset coming into use.

Issue 9 :

S Ltd. revalues the fixed assets in conformity with AS 10, fixed assets, with effect from 1-4-03. S Ltd. is following straight line method of depreciation at the rates prescribed in schedule XIV of the Companies Act, 1956. Should S Ltd. continue to provide depreciation at the rates prescribed in schedule XIV for the revalued assets ?

☞ As per AS 6, where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. Accordingly S Ltd. will have to provide depreciation on revalued assets considering the estimate of the remaining useful lives of such assets. Accordingly S Ltd. will have to provide depreciation on revalued assets considering the estimate of the remaining useful lives of such assets and not at the rate as prescribed in schedule XIV of the Companies Act 1956, as hitherto followed.

In connection therewith, S Ltd. will also be required to provide depreciation on the total book value of the fixed assets, including the increased amount as a result of revaluation in the profit and loss account of the relevant period. S Ltd. can have option to transfer an amount equivalent to the additional depreciation from the Revaluation Reserve. Such transfer from Revaluation Reserve should be shown in the Profit and Loss account separately.

Issue 10 :

In case of addition to fixed assets, which otherwise forms an integral part of the existing asset, how is depreciation provided on such addition ?

☞ AS 6, Depreciation accounting states that any addition or extension to an existing asset which is of a capital and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset.

However, any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

Issue 11 :

M Ltd. is in manufacturing of steel. M Ltd. is following written-down value method for providing depreciation. During accounting year 03-04, M Ltd. commenced manufacturing cement. Cement division of M Ltd. wants to provide depreciation on straight line method. Can M Ltd. do so ?

☞ AS 6, mentions that the management of a business selects the most appropriate method(s) based on various important factors e.g. (i) type of asset (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. Since, the Fixed Assets of cement division are not similar in nature and use as that of steel division, M Ltd. can follow a straight line method of depreciation for cement division.

Issue 12 :

What are the disclosure requirements required by AS 6 Depreciation accounting?

☞ Over and above the requirements of schedule VI of the Companies Act 1956, AS 6 requires the following information to be disclosed in the financial statements :

- (i) the historical cost or other amount substituted for historical cost of each class of depreciable assets.
- (ii) total depreciation for the period for each class of assets,
- (iii) the related accumulated depreciation
- (iv) accounting policy as to the depreciation method used and the depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

Depreciation vis-à-vis Amortisation :

The accounting profession as well as the industry in India, have been extensively using only one terminology i.e. Depreciation. However, over last few years the concept of amortisation is gaining equal importance. The words depreciation and amortisation are used for different assets. For fixed assets of tangible nature such as Building, Plant and Machinery, Vehicles, Furniture & Fixtures the word depreciation is used, whereas fixed assets of intangible nature such as Patents, Trade Marks, Goodwill, Software, Technical know-how etc. the word amortisation is used. AS 6 specifically deals with depreciation where as AS 26, deals with Intangible assets and its amortisation. Thus, now we have different accounting standards which deal with write-off of fixed assets either in form of depreciation or amortisation. The rates of write-off will again differ depending upon various factors. As regards depreciation is concerned, in India ready made rates are made available in schedule XIV of the Companies Act, 1956. Whereas AS 26 which is of recent origin, permits amortisation based on

Management's estimate of useful life of the asset, but not to exceed ten years except where there is a persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years.

Both Tangible and Intangible assets are shown under the head fixed assets but presented separately. Thus, now we encounter the word Depreciation and Amortisation instead of one terminology Depreciation. Disclosure requirements of AS 6, Depreciation Accounting and AS 26, Intangible Assets have to be complied with in presentation of financial statements.

With AS 26 becoming applicable w.e.f. 1-4-03 for listed companies, a common item say Goodwill or Trade Mark appearing in Financial Statements is subject to amortisation. Thus, intangible assets such as Goodwill or Trademark can no more be carried indefinitely in financial statements at cost.