<u>GUIDANCE NOTE ON ACCOUNTING FOR DEPRECIATION IN COMPANIES</u>

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Methods of Charging Depreciation

Section 205 of the Companies Act, 1956, prescribes the methods of charging depreciation. The relevant extracts thereof are as follows:

"(2)....depreciation shall be provided either-

(a) to the extent specified in section 350; or

(b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five percent of the original cost thereof to the company by the specified period in respect of such asset; or

(c) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five percent of the original cost to the company of each such depreciable asset on the expiry of the specified period; or

(d) as regards any other depreciable asset for which no rate of depreciation has been laid down by this Act or rules made thereunder, on such basis as may be approved by the Central Government by the general order published in the Official Gazette or by any special order in any particular case.

(5) 'Specified period' in respect of any depreciable asset shall mean the number of years at the end of which at least ninety-five per cent of the original cost of the asset to the company will have been provided for by way of depreciation if depreciation were to be calculated in accordance with the provisions of section 350."

If no provision is made for depreciation, the fact that no provision has been made should be stated and the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act shall be disclosed by way of a note.

Adoption of different methods for different types of assets:

A company may adopt more than one method of depreciation. Thus, it is permissible to follow different methods for different types of assets

provided the same methods are consistently adopted from year to year in accordance with Section 205(2). Also, units in different geographical locations can follow different methods of depreciation provided the same are consistently followed.

Change in the method of providing depreciation:

Only in following conditions:

- for compliance of Accounting Standard
- for compliance of law
- the change would result in a more appropriate preparation or presentation of the financial statement of the enterprises

Procedure to be followed in case of change in method:

- Depreciation to be calculated using new method from beginning to till date

- Difference in depreciation= New Depreciation – Old Depreciation
- Surplus Depreciation credited to Profit & Loss Account as Depreciation Written back
- Deficiency in Depreciation debited to Profit & Loss Account

Relevant Rates of Depreciation for the Purpose of Preparation of Accounts of a Company:

A company can use higher rate of depreciation if it represent true commercial depreciation i.e., the rate which is adequate to write off the asset over its normal working life. but the company cannot provide the lower rate of depreciation than the rate prescribed in Schedule XIV, since these represent the minimum rates of depreciation to be provided

In case a company adopts the higher rates of depreciation as recommended above, the higher depreciation rates/lower lives of the assets must be disclosed.

the rates as contained in Schedule XIV should be viewed as the minimum rates, and, therefore, a company will not be permitted to charge depreciation at rates lower than those specified in the Schedule.

On the basis of bona fide technological evaluation, higher rates of depreciation are justified, they may be provided with proper disclosure by way of a note forming part of annual accounts"

Depreciation on Extra Shifts:

Schedule XIV requires that where the concern has worked extra shift, the multiple or extra shift depreciation will have to be provided on the plant
and machinery, wherever applicable.

In cases where depreciation has not been provided in respect of extra or multiple shifs allowance, it will be necessary for the auditor to qualify his report accordingly. An example of the qualification is given below:

Depreciation in respect of extra or multiple shift allowance amounting to rupees .... has not been provided which is contrary to the provisions of Schedule XIV to the Companies Act. This has resulted in the profit being overstated by Rs .... and plant and machinery overstated by Rs..........".

Pro-rata Depreciation

Where, during any financial year, any addition has been made to any asset,or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a pro rata basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed".

A company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved.

Depreciation on Low Value Items

many companies used to follow the practice of writing off low value items in the year of acquisition, since such a write off was permitted under the Income-tax Act. The limit for such a write off was Rs. 5,000/-.

Schedule XIV is, however, silent on this aspect. The concept of materiality should be kept in mind while deciding the amounts to be written off in this regard.

Charging of Depreciation in Case of Revaluation of Assets

The Revaluation Reserve is not available for payment of dividends. Similarly, accumulated losses or arrears of depreciation should not be set off against Revaluation Reserve. However, the Revaluation Reserve can be utilised for adjustment of the additional depreciation on the increased amount due to revaluation from year to year or on the retirement of the relevant fixed assets.