Depreciation Policy of Companies in India

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The successful management of a company demands a correct approach towards the problem of depreciation. In considering the earning capacity of a company, one of the principal factors to be taken into account is the extent of the provision that has been made in the past or has to be made in the future for depreciation. The need for such provision is recognised by the managers of all soundly managed companies in all countries. The Income-tax law in India, as in other countries, also recognises the need by allowing for depreciation in respect of assets at the statutory income-tax rates. The quality of managerial judgment in the solution of this problem determines the amount of profit which a company will earn.

Before finally settling the amount of profit available for distribution, the question of depreciation has to be carefully considered. "This is a most important matter for which the directors are completely responsible. The fixed assets gradually lose their value, more or less according to the manner in which they are used; and for this reason no company can be said to have made a fair profit until, in addition to the expenses of its business, there has been charged against the revenue a proper amount for depreciation in respect of its fixed assets." Possibly no single problem of company finance is as difficult of solution as that growing out of the maintenance of the capital of the company intact while paying out net income to the shareholders.

Depreciation may be defined as "the loss, not restored by current maintenance, which is due to all the factors, causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy and obsolescence." As an accounting item it is the amount written off an asset to provide for its ultimate retirement. Depreciation on account of wear and tear may be estimated in advance with some accuracy, but depreciation for obsolescence is always of uncertain amount. Therefore, definitions which imply that depreciation for the year is a measurement, expressed in monetary terms, of the physical deterioration or of the decline in value within the year are unacceptable. Depreciation accounting means to distribute the cost or other basic value of tangible capital assets over the estimated useful life of the unit. It is a process of allocation, not of valuation. Although the allocation may properly take into account occurrences during the year, "it is not intended to be a measurement of the effect of all such occurrences."

There is a very common tendency to confuse depreciation accounting and the financing of replacements. As a matter of fact depreciation represents the extreme example of prepayment, it is not designed to adjust an asset to value, but it is merely the cost of that portion of the total serviceability of the asset which—according to the best estimates available—lies been used up to date. The effect of making provision for depreciation is to reduce the reported net income by the provision for depreciation which would otherwise be shown to that extent more during the estimated useful life of the asset. This reduction in profit has an important effect on the management of earnings, particularly through the restriction of dividend payments. The company will have cash available to the extent that dividend payments are thus restricted. It would be a mistake, however, to consider the purpose of the charge for depreciation to be to provide for the replacement of assets, and there is no necessary connection between the provision made for depreciation of one asset and the cost of a new asset even if it is obviously a direct replacement.

Accounting of a "going Concern"

The question may well arise whether the accounting concepts of depreciation will adequately prepare for a "going concern" operation. That is, will the accounting depreciation process while maintaining rupee values in the business fail to prepare "purchasing power" values? For the economic process of the business, management must replace the capital equipment at the reproduction cost figures and thus the company has a practical reason for preparing for a possible price increase. There is evidence in plenty these days to show that the present depreciation charges based on money costs or original acquisition are inadequate to replace the expiring real capital values or "the economic value of capital."

Managerial policies may be mis-guided if managers are not warned, therefore, that the reported money earnings shown on the accounting depreciation basis may not be a sound guide for their current action, it is pointed out. Some have raised the question whether or not the fraud of the accountant to assist at this point may not lead the businessman to so misjudge circumstances as to add to the violence of boom and bust periods.

If it be accepted that there is merit in this problem of replacement values and yet recognition is given to the accounting concepts, the important question is whether a realistic representation can be made. A general contingency reserve directed toward the provision of added capital for price changes in the cost of assets may be the proper answer. Capital is not impaired if the cost of a fixed asset is absorbed in operations by depreciation charges based on cost; additional funds required for the replacement of assets at higher prices can be retained from profits by a limitation of dividends. The theory underlying the provision of depreciation on the basis of replacement cost to prevent an impairment of capital is based on the assumption that a business must retain, as a realisation of deliberately overstated costs, rather than by limitation of dividends, a sum sufficient to replace the fixed assets at current prices. The creation of a general contingency reserve would recognize that the cost for replacement of assets may not be in price changes alone but in technological changes as well. Financing the replacement of retired assets is a separate financial problem and only concerns accountancy so that the records may reflect that policy.

Depreciation in Indian Companies Act

Although, in addition to expenditure on renewals and repairs of fixed assets, all well-conducted concerns make provision for depreciation whenever they earn profits, yet there is no statutory obligation to do so, unless the memorandum or the articles of the company so provide. Regulation 107 of Table A,
of the Indian Companies Act, which prescribes the contents of the profit and loss account, does not mention that depreciation should always be provided for, because it merely states that every item of expenditure fairly chargeable against a year's income shall be brought into account. A specific reference to depreciation in the Indian Companies Act is contained in the provision prescribing the basis of remuneration payable to managing agents in agreements entered into after 15th January, 1937. In sub-section (3) of section 87c, the net profits on which the remuneration is to be assessed are defined as profits calculated altering allowing the usual working charges and depreciation. The basis for providing for this depreciation is, however, not prescribed and it is left to the discretion of a company that discretion rests in the matter of determining the depreciation to be provided for.

It is very necessary, therefore, that a proper provision for depreciation should be made in the profit and loss account before arriving at the amount of true profits. Depreciation should be regarded in the nature of working expense. It is not a disposition of a part of the profits, but an expense without which profits can never be earned. In practice depreciation is looked upon by company managements in some cases as working expense, but there are many instances where depreciation is not deducted for ascertaining profits, although it must be before giving a dividend. It means that in the majority of cases provision for depreciation is made only when there are profits, and it is not regarded as a working expense. If there are no profits, depreciation is not provided for, but the arrears of depreciation are carried forward to be made good in future when there may be profits. On the other hand, in the case of companies under the management of managing agents, who follow a prudent and conservative financial policy, provision for depreciation is always made before arriving at the figure of profit or loss.

Unorthodox Procedure

It is only the wrong conception of depreciation that leads to arrears of depreciation. It is wrong to assume that a fixed relation exists between net earnings and depreciation requirements. Irregularity of depreciation charges is usually condemned by both accountants and economists, for the logical inference of the policy is that no depreciation occurs unless there are profits, if the orthodox method is followed, viz., if depreciation is provided for whether there are profits or not, there can be no question of arrears of depreciation. In the case of some of the cotton mill companies, depreciation is on the recommendation of directors finally sanctioned by the shareholders in general meetings. But this is rather an unusual procedure.

Overdoing It

The provision for depreciation should be calculated in a scientific way. The exact method of assessing the amount of depreciation to be provided for depends largely upon the financial policy pursued by the management of a company. Where a conservative and cautious policy is adopted more than the necessary amount of depreciation is charged in the accounts. There are many instances of over-depreciation in the Eastern Capital when the European managing agents have followed consistently a policy of cautious finance in the matter of providing depreciation. By following this policy of generous depreciation, instead of reserves exist in many companies. Some authorities have questioned the general approbation of the creation of reserves for depreciation, and the almost general approbation by businessmen of reserves deliberately in excess of requirements and have found it difficult to understand. Some of the effects of the creation of reserves for depreciation are not generally understood, but the amounts charged in their creation are so large that much further study of them is obviously desirable. No well defined policy as to the investment of these funds can be discovered, and no analysis has been made of accounts to show the extent to which excessive cash balances and outside investments can be set against these reserves, or to what extent they have been reinvested in the business creating them.

Scale Down Basis

Quite a large number of companies in India are now adopting the method of providing for depreciation on the scale-down or written-down basis at the rates allowed for income-tax purposes, if the profits permit such a course. Prudent managing agents, however, make provision for special depreciation as well, in addition to the normal allotment at the statutory income-tax rates.

Straight-Line Method Favoured

Most commonly employed in industrial and commercial concerns in UK are the straight-line method and the reducing balance method. The straight-line method is used almost universally in the USA and Canada and to a large extent in Britain. Though other methods may be appropriate in the case of some classes of assets, the balance of informed opinion now favours the straight-line method as being the most suitable for general application. The straight-line method is also recommended by the Institute of Chartered Accountants in England and Wales as the most suitable in the majority of cases.

Unfortunately, however, in the case of many companies in India, frequently provision for depreciation is not made on merits but is made on extraneous considerations. 'The practice of writing off depreciation irregularly by arbitrarily setting aside such sums as can conveniently be spared out of the annual profits is one that cannot be recommended. This practice, is followed, it is true, by some of our well-managed concerns. But it is essentially unsound. Depreciation is not a theory or a vague notion in some one's head; it is an actual element in the operation of every business; it is going on day and night; through all seasons; year after year in periods of depression as well as in periods of prosperity. The losses due to depreciation should constitute, therefore, a regular charge against gross income.'

Physical and 'Functional'

In the West, most concerns make some provision for obsolescence in addition to that made for depreciation. In India, however, few concerns make such provisions. When many concerns in India do not provide adequately even for physical depreciation, it is too much to expect them to provide for 'functional' depreciation. But it is very necessary that sufficient attention should be paid to obsolescence also in addition to physical depreciation. Although it is not possible to make a correct forecast about obsolescence, that is no reason why it should not be taken into consideration. In calculating the provision for obsolescence past history of the development of that fixed asset, viz., machinery, etc, in that particular industry should be taken into consideration which might help sometimes in calculating...
accuracy the period after which a new invention would appear in that type of machinery.

Replacement at Higher Cost

The burning question of the moment, however, is that of replacement of assets at current prices. The problem has arisen in an acute form because the costs of capital goods have gone up so high, that the amount set aside for depreciation on the basis of original costs is woefully insufficient to meet the cost of replacing these assets. Looking at the problem from the point of view of sound company finance, the management of companies should have thought in advance for this eventuality and provided for it during the period of high prices, i.e., a part of the profits resulting from high prices should have been set aside to cover the rising cost of replacement. This has not been done except by a handful of companies. If industrialists had built up a special reserve fund out of the large profits earned during those years for the purpose of replacement, the problem would not have been so serious today. The magnitude of the problem will become clear from the fact that the arrears of depreciation have been estimated by the Planning Commission to be between Rs 100 to Rs 150 crores at the end of 1949-50. The problem has been aggravated further because of the practical difficulties of securing the required finance by resorting to the capital market.

In conclusion, it can be said that the problem of depreciation has not been given its rightful place in the development of company finance by persons responsible for the management of joint-stock companies in India. Notwithstanding the fact that provision for depreciation of fixed assets is not legally necessary, while determining profits for distribution, depreciation should be treated as a charge against profits rather than as an appropriation of profits, because no company can expect to carry on successfully without making an adequate provision for depreciation. And the adequacy of depreciation should be scientifically calculated and should not vary with the profits earned nor should it be made to rest on the interests of the management. Obsolescence and increased cost of replacement should also be adequately provided for by setting aside suitable reserves for them.