A Comparative Study on Depreciation as Per Companies Act and Income Tax Act in Indian Context

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Abstract

Depreciation means diminution in the value of an asset due to wear and tear due to time. Depreciation is calculated annually based on the methods specified in the relevant statute. Companies Act prescribes two methods for calculating depreciation – Straight Line Method (SLM) and Written Down Value Method (WDV). Companies Act, 1956 specified rates of depreciation in Schedule XIV for SLM as well as WDV Method whereas Companies Act, 2013 specifies useful life of various class of assets in Schedule II, as a basis to determine the rate of depreciation under SLM, WDV or UOP (Unit of Production) method. As per Income Tax Act, 1961, it is mandatory to calculate depreciation as per Block of Assets criteria by following Written Down Value Method. The method of depreciation selected affects the profit as well as the carrying value of assets of an enterprise.

The paper discusses the effects of these methods of depreciation used under two relevant statutes, on the financial statements of an Indian Company. The paper also analyzes the need of autonomy required under the Income Tax Act, to follow depreciation methods in line with the methods of depreciation to be used as per the governing statute. The paper emphasizes on the fact that the distinct methods of depreciation under the two relevant statutes namely the Companies Act and the Income Tax Act leads to a difference in the figures reported for accounting purpose and for taxation purpose. This difference can be removed if the methods of depreciation coincide under both relevant statutes.

Key Words
Original Cost, Residual Value, Useful Life, Companies Act, Income Tax Act, Depreciation

Introduction

Depreciation is claimed by business enterprises for two purposes - Accounting Purpose and Taxation Purpose. In accountancy, depreciation refers to two aspects - decrease in the value of assets and allocation of cost of assets to the useful life of assets. In taxation, depreciation refers to reduction in net taxable income to reduce the amount of tax payable.

Indian Companies Act, 1956 has been replaced by Companies Act, 2013. Consequently Schedule XIV of Companies Act, 1956 has been withdrawn and Schedule II of Companies Act, 2013 is applicable for the purpose of depreciation of assets, with effect from 1st April, 2014 in case of a company. Method of computation of depreciation has changed with the implementation of Schedule II. From rate based approach the shift is made towards useful life of assets as a basis for determining the rate of depreciation. However, the method of calculating depreciation under the Income Tax Act, 1961 is in continuance till date where block of assets criteria is used to calculate depreciation.

Depreciation methods differ for accounting purpose and for taxation purpose. Resultantly, the amount of depreciation as per Companies Act and as per Income Tax Act also differ. This gives rise to a timing difference, which requires to be quantified in financial statements in the form of deferred tax liability / asset.

Meaning of Specific Terms

- Depreciation
  According to the Institute of Chartered Accountants of India ”Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of an asset. Depreciation includes amortization of assets whose useful life is predetermined.”

- Depreciable Asset
  Depreciable assets are assets which are expected to be used during more than one accounting period and have a limited useful life and are held by the enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

- Useful Life
  The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

- Depreciable Amount
  Depreciable amount of a depreciable asset is its historical cost or other amount substituted for historical cost in the financial statements, less estimated residual value.

Methods of Depreciation

- Methods of Depreciation and useful life of depreciable assets may vary for assets of different types and different industries and may vary for accounting and taxation purposes also. Most commonly employed methods of depreciation are Straight Line Method and Written Down Value Method.

- Methods of depreciation as per Companies Act, 1956 (Based on Specified Rates):
  - Straight Line Method
  - Written Down Value Method

- Methods of depreciation as per Companies Act, 2013 (Based on Useful Life of assets):
  - Straight Line Method
  - Written Down Value Method
  - Unit of Production Method

- Methods of depreciation as per Income Tax Act, 1961 (Based on Specified Rates):
  - Written Down Value Method (Block wise)
  - Straight Line Method for Power Generating Units

Schedule XIV to the Companies Act, 1956 V/s Schedule II to the Companies Act, 2013

- Basis for Depreciation Calculation
  As compared to Schedule XIV of the Companies Act, 1956, Schedule II of the Companies Act, 2013, instead of specifying the rates of depreciation for various assets, specifies that depreciation should be provided on the basis of useful life of an asset.

- Prescriptive V/s Indicative
  Schedule XIV was prescriptive in nature as it specified minimum rates of depreciation. The Company was not permitted to charge lower rate of depreciation than specified in Schedule XIV. However, higher rate of depreciation were allowed provided sufficient technical evidence is provided with proper disclosure by way of a note in financial statements.

  Schedule II is indicative in nature as it indicates the useful lives of various assets. As per Schedule II Companies can adopt higher or lower life than those specified in the schedule supported by technical advice.

- Rates V/s Useful Life
  Schedule XIV prescribed rates of depreciation under Straight Line Method and Written Down Value Method for various class of assets.

  Schedule II prescribes useful life of an asset for the purpose of calculating depreciation. The useful life of an asset shall not be ordinarily different from the life specified in Part C of Schedule II. Company may adopt useful life separate from that specified in Part C provided it makes a proper disclosure in financial statements and provides justification supported with technical advice.

- Methods of Depreciation
  Schedule XIV prescribed rates of depreciation primarily under Straight Line Method and Written Down Value Method for different class of assets.

  Schedule II specifies three methods of depreciation – Straight Line Method (SLM), Written Down Value Method (WDV) and Unit of Production Method (UOP) for calculating depreciation based on useful life of an asset.

- Residual Value
  Schedule XIV specified that depreciation shall be calculated on historical cost less residual value. However, limit of residual value of an asset was not prescribed for the purpose of calculating depreciation.

  Schedule II specifies that the residual value of an asset shall not exceed 5% of its original cost. Company can adopt a residual value different from the limit specified above if it makes proper disclosure and provides justification supported by a technical advice.

- Amortization of Intangible Assets

No method was suggested for amortization of intangible assets in Schedule XIV except for amortization of intangible assets Toll Roads created under Build, Operate and Transfer or any other Public Private Partnerships.

Schedule II specifies that intangible assets shall be amortized as per the provisions of AS – 26 Intangible Assets. AS – 26 specifies that intangible assets should be amortized in the ratio of future economic life of the asset.

- Depreciation on assets up to Rs.5000/-
  Schedule XIV specified 100% depreciation for assets whose cost does not exceed Rs.5000/- whereas Schedule II does not specify for 100% depreciation for assets whose cost does not exceed Rs.5000/-

- Extra Shift Depreciation
  Schedule XIV specified that depreciation for double and triple shift to be provided separately in proportion of number of days for which the company worked for double or triple shift bears to normal working days in a year.

  Schedule II specifies for 50% increase in depreciation for the period for which the asset is used for double shift and 100% increase in depreciation for the period for which the asset is used for triple shift.

- Component Accounting
  Schedule XIV specified that component accounting approach was optional. Company may adopt component accounting approach.

  Schedule II has made component accounting mandatory. If the cost of a component is significant to total cost of an asset and the useful life of that component is different from the useful life of an asset, then the company will have to estimate useful life of the component separately and will have to provide for depreciation on significant components separately than the asset.

- Transitional Provision under Schedule II
  From the date Schedule II comes into effect i.e. 1st April, 2014, the carrying amount of the asset as on that date
    - Shall be depreciated over the remaining useful life of the asset
    - After retaining the residual value, may be recognized in the opening balance of retained earnings or may be charged off to Profit and Loss account where the remaining useful life of an asset is nil.

  Hence, the company will have to reassess the useful life of its existing fixed assets in accordance with Schedule II.

Depreciation provisions under Income Tax Act, 1961

Income tax act, 1961 prescribes block of assets for calculating depreciation. A block of asset means a group of assets clubbed in one block for the purpose of calculating depreciation. Similar assets with same rate of depreciation are grouped to form a block of asset. Individual assets lose identity under Income Tax Act as depreciation is calculated on the block of assets rather than on individual asset.

Income Tax Act, 1961 has prescribed rates of depreciation for 13 block of assets wherein 12 blocks are for tangible assets and 1 block is for intangible assets. Depreciation is calculated by using Written Down Value Method for income tax purpose in India (except for power generating units where Straight Line Method is used).

- Written down value of block is determined as follows for the purpose of calculating depreciation:

Particulars	Rs.
Opening WDV of the block of assets	xxx
Add: Cost of assets purchased during the year	xxx
Sub-Total	xxx
Less: Sale value of assets sold during the year	xxx
Written down value for the purpose of depreciation	xxx

- Put-to-use criteria for calculating depreciation
    - Assets put-to-use for more than 180 days in the year of purchase = Full Rate Depreciation in the year of purchase.
    - Assets put-to-use for less than 180 days in the year of purchase = Half Rate Depreciation in the year of purchase

- Additional Depreciation on new Plant and Machinery
  An industrial undertaking can claim additional depreciation on purchase of new plant and machinery used by the assesse in his business for the purpose of manufacture of article or things, subject to specified conditions. Additional depreciation can be claimed in the year of purchase at 20% if new plant and machinery is put-to-use for more than 180 days and at 10% if new plant and machinery is put-to-use for less than 180 days.

Formula for Calculating Depreciation

- Schedule XIV prescribed rates of depreciation under SLM and WDV method, wherein depreciation calculation would be as follows:
    - Straight Line Method
        - Depreciation = Original Cost * Rate of Depreciation under SLM
    - Written Down Value Method
        - Depreciation = Written Down Value * Rate of Depreciation under WDV Method

- Schedule II prescribes useful life of an asset as a base for calculating depreciation. The rate of depreciation shall be determined on the basis of useful life of an asset as follows:
    - Straight Line Method
        - Rate of Depreciation = $\frac{[\text{ (Original Cost – Residual Value) / Useful Life] * 100}]}{\text{Original Cost}}$
        - Depreciation = Original Cost * Rate of Depreciation under SLM
    - Written Down Value Method
        - Rate of Depreciation = [1 – (s/c) ^ 1/n] * 100

Where s = Scrap Value of the asset at the end of useful life
c = Original Cost of the asset
n = Useful life of the asset

- Depreciation = WDV * Rate of Depreciation under WDV

- Income Tax Act,1961
  - Written Down Value Method
    - Rate of Depreciation = Rate for block of asset prescribed under Income Tax Act
    - Depreciation = WDV of block * Rate of Depreciation under WDV

Example

Sr. No.	Name of Asset	Original Cost (Rs.)	SLM Rate as per Sch. XIV	WDV Rate as per Sch. XIV	Useful Life as per Sch. II	Rate of Depreciation as per Income Tax Act, 1961
1.	Factory Building	30,00,000	3.34%	10.00%	30	10.00%
2.	Other Building	18,00,000	1.63%	5.00%	60	10.00%
3.	Plant & Machinery	12,00,000	4.75%	13.91%	15	15.00%
4.	Motor Cars	5,00,000	9.50%	25.89%	8	15.00%
5.	Furniture & Fittings	10,00,000	6.33%	18.10%	10	10.00%

Comparison of Depreciation under SLM as per Schedule XIV and Schedule II – for all years

Asset	Original Cost	SLM Rate as per Sch. XIV	Scrap Value@ 5% as per Sch. II	Depreciable Amount as per Sch.II (b – d)	Useful Life as per Sch. II	Depreciation as per Schedule XIV (b * c)	Depreciation as per Sch. II (e / f)
a	b	c	d	e	f	g	h
	Rs.	%	Rs.	Rs.	Years	Rs.	Rs.
Factory Building	3000000	3.34%	150000	2850000	30	100200	95000
Other Building	1800000	1.63%	90000	1710000	60	29340	28500
Plant & Machinery	1200000	4.75%	60000	1140000	15	57000	76000
Motor Car	500000	9.50%	25000	475000	8	47500	59375
Furniture & Fixtures	1000000	6.33%	50000	950000	10	63300	95000

Table 1 : Determination of Rate of Depreciation under WDV method as per Schedule II

Asset	Original Cost	Scrap Value@5% as per Sch. II	Useful Life as per Sch. II	Factor [(c/b) ^ (1/d)]	WDV Rate of Depreciation as per Sch. II [(1 – e) * 100]
A	b	c	d	e	f
	Rs.	Rs.	Years	No.	%
Factory Building	3000000	150000	30	0.90	9.50%
Other Building	1800000	90000	60	0.95	4.87%
Plant & Machinery	1200000	60000	15	0.82	18.10%
Motor Car	500000	25000	8	0.69	31.23%
Furniture & Fixtures	1000000	50000	10	0.74	25.89%

Table 2 : Comparison of Depreciation under WDV method as per Schedule XIV and Schedule II – 1st Year

Asset	Original Cost	WDV Rate as per Sch.XIV	Scrap Value @5% as per Sch. II	Depreciable Amount as per Sch.II (b – d)	Useful Life as per Sch. II	WDV Rate of Depreciation as per Sch. II determined in Table 1 above	Depreciation as per Sch.XIV (b * c)	Depreciation as per Sch. II (b * g)
a	b	c	d	e	f	g	h	i
	Rs.	%	Rs.	Rs.	Years	%	Rs.	Rs.
Factory Building	3000000	10.00%	150000	2850000	30	9.50%	300000	285000
Other Building	1800000	5.00%	90000	1710000	60	4.87%	90000	87660
Plant & Machinery	1200000	13.91%	60000	1140000	15	18.10%	166920	217200
Motor Car	500000	25.89%	25000	475000	8	31.23%	129450	156150
Furniture & Fixtures	1000000	18.10%	50000	950000	10	25.89%	181000	258900

Table 3 : Comparison of Depreciation under WDV method as per Schedule XIV and Schedule II – 2nd Year

Asset	WDV as per Sch.XIV (Original Cost – Dep as per Column h of table 2 above)	WDV Rate as per Sch.XIV	WDV as per Sch.II (Original Cost – Dep. As per Column i of table 2 above)	WDV Rate of Depreciation as per Sch.II	Depreciation as per Sch.XIV (b * c)	Depreciation as per Sch. II (d * e)
a	b	c	d	e	f	g
	Rs.	%	Rs.	%	Rs.	Rs.
Factory Building	2700000	10.00%	2715000	9.50%	270000	257925
Other Building	1710000	5.00%	1712340	4.87%	85500	83391
Plant & Machinery	1033080	13.91%	982800	18.10%	143701	177887
Motor Car	370550	25.89%	343850	31.23%	95935	107384
Furniture & Fixtures	819000	18.10%	741100	25.89%	148239	191871

Block of Assets for Income Tax purpose – Similar class of assets with same rate of depreciation are clubbed in one block and depreciation is calculated on the block.

Sr. No.	Name of Asset	Original Cost (Rs.)	Rate of Depreciation as per Income Tax Act, 1961	Block
1.	Factory Building	30,00,000	10%	Block 1 – Building 10%
2.	Other Building	18,00,000	10%	Block 1 – Building 10%
3.	Plant & Machinery	12,00,000	15%	Block 2 – Plant & Machinery 15%
4.	Motor Cars	5,00,000	15%	Block 2 – Plant & Machinery 15%
5.	Furniture & Fittings	10,00,000	10%	Block 3 – Furniture 10%

Calculation of Depreciation as per Income Tax Act, 1961 – 1st year
(Assuming opening wdv as zero and assets put-to-use for more than 180 days)

Particulars	Block 1 Building	Block 2 Plant & Machinery	Block 3 Furniture
	10%	15%	10%
	Rs.	Rs.	Rs.
Opening WDV	---	---	---
Add: Cost of assets purchased during the year	4410000	1403630	819000
	4410000	1403630	819000
Less: Sale Value of assets sold during the year	---	---	---
WDV for the purpose of depreciation	4410000	1403630	819000

Less: Depreciation for 1st year	441000	210545	81900
Closing WDV	3969000	1193086	737100

Calculation of Depreciation as per Income Tax Act, 1961 – 2nd year
(Assuming purchase and sale to be nil)

Particulars	Block 1 Building	Block 2 Plant & Machinery	Block 3 Furniture
	10%	15%	10%
	Rs.	Rs.	Rs.
Opening WDV	3969000	1193086	737100
Add: Cost of assets purchased during the year	---	---	---
	3969000	1193086	737100
Less: Sale Value of assets sold during the year	---	---	---
WDV for the purpose of depreciation	3969000	1193086	737100
Less: Depreciation for 1st year	396900	178963	73710
Closing WDV	3572100	1014123	663390

Result

Year	Total Depreciation under SLM Method		Total Depreciation under WDV Method		Depreciation as per Income Tax
	Sch. XIV	Sch. II	Sch. XIV	Sch. II	Sec.32
	Rs.	Rs.	Rs.	Rs.	Rs.
1st Year	297340	353875	867370	1004910	733445
2nd Year	297340	353875	743376	818458	649573

Conclusion

Companies are required to calculate depreciation as per Company Act as well as Income Tax Act. The methods and amount of depreciation differ under both the statutes. Companies are required to maintain two types of depreciation calculation – one for accounting purpose following Schedule II to the Companies Act, 2013 and the other for taxation purpose according to the provisions of Sec. 32 of Income Tax Act, 1961.

Shift depreciation concept is specified in Schedule II which allows to claim extra depreciation in any year if the assets are used for double or triple shift. Such extra depreciation cannot be claimed under the provisions of income tax except additional depreciation in the year of purchase on new plant and machinery used for manufacture. If company is following straight line method of depreciation then the amount of depreciation will remain same for all years in accounts. Whereas the depreciation as per income tax will show a decreasing trend year after year. All such differences in the methods of depreciation under the two relevant statutes leads to a timing difference which requires creation of deferred tax asset/liability.

Due to the rigidity of method of depreciation under income tax act, the figures of financial statements and taxation figures never coincide. This makes maintenance and comparison of accounting records and taxation statements very difficult.

These facts reveal that Income tax act should allow the usage of different methods of depreciation suitable to varied industries which should accord with the governing statute too. Enterprises should have liberty to use straight line method, written down value method or unit of production method for calculating depreciation even for taxation purpose. Resultantly, the duplication of calculation could be reduced and comparison of accounting and taxation records could be made easier.

References

- Schedule XIV to the Companies Act, 1956
- Schedule II to the Companies Act, 2013
- Application guide to Schedule II of Companies Act, 2013
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- Section 32 of Income Tax Act, 1961