

Depreciation Accounting Standards: A Comparative Study of Accounting Standards on Depreciation in India and United Kingdom

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INTRODUCTION

Accounting is treated as language of business, which communicates the financial results of an enterprise to different interested parties by means of financial statements. Accounting bodies have developed certain rules, which are to be followed by the accountants in the preparation of financial accounts. However, these rules have to be used with a reasonable degree of flexibility after considering the specific circumstances of a particular enterprise and also economic environment, social needs, legal requirements and technological developments. Though these accounting rules are not rigid like physical sciences, yet the accountants have to operate within the bounds of rationality, objectivity and consistency. Because of these flexibilities, many diverse practices have been recognized over a period of years. The need for harmonizing these diverse policies and practices was felt in order to make the financial statements more understandable and comparable. It was felt that if some standard accounting policies or practices were prescribed, it would narrow down the differences. This can be considered as a genesis for setting the accounting standards. Accounting standards are the policy documents issued by a recognized expert accountancy body relating to various aspects of measurement, treatment and disclosure of accounting transactions and events. The main purpose of accounting standards is to standardize diverse accounting policies with a view to eliminate, to the extent possible, incomparability of financial statements information and provide a set of standard accounting policies, valuation norms and disclosure requirements to discourage pursuance of accounting policies which are not in conformity with generally accepted accounting policies. In different countries, there are different standard setting bodies.

Recognising the need for international harmonisation of accounting standards, in 1973, the International Accounting Standards Committee (IASC) was established. The IASC has been restructured now as International Accounting Standards Board (IASB). The objectives of IASB include promotion of the International Accounting Standards for worldwide acceptance and observance so that the accounting standards in different countries are harmonised. In recent years, need for harmonisation of accounting standards followed in different countries has grown considerably, as the cross-border transfers of capital are becoming increasingly common.

OBJECTIVES

In this project, accounting standards relating to depreciation accounting in India and United Kingdom and Republic of Ireland have been considered. The main objectives of this study are:

1. To discuss the text of the above-mentioned accounting standards concerning depreciation;
2. To locate the differences or similarities amongst these standards.

INDIAN ACCOUNTING STANDARDS: In India, two accounting standards Viz. (AS-6 and AS-10) are concerned with "DEPRECIATION ACCOUNTING" and "ACCOUNTING FOR FIXED ASSETS" respectively and are issued by Institute of Chartered Accountants of India.

ACCOUNTING STANDARD OF UNITED KINGDOM AND REPUBLIC OF IRELAND: (FRS -15) for "TANGIBLE FIXED ASSETS" is issued by Accounting Standard Board in respect of its application in the United Kingdom and by Institute of Chartered Accountants in Ireland in respect of application in Ireland.

After going through the prevailing accounting standards in India and UK, a scheme of comparison under the following major heads has been made:

1. Initial Measurement of Asset.
2. Valuation of Asset.
3. Depreciation.
 - a. Rates of depreciation.
 - b. Depreciation Methods.
 - c. Change of method.
4. Review of useful economic life.
5. Disclosures.

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Initial Measurement

This has been subdivided into following costs which have been considered by different standards:

- (A) Initial Cost
 - (B) Financial Costs
 - (C) Subsequent Expenditure
- (A) INITIAL COST**

As far as the initial cost is concerned the above standards are, more or less, of the same view that fixed asset should initially be measured at its costs. Costs mean the items of expenditure that are directly attributable to bringing the asset into working condition for intended use.

(B) FINANCIAL COST

a. Indian standard "AS-16", "Borrowing Costs" and "FRS-15" explains this item of cost near about in a similar manner. In this process of explanation, FRS -15 says:

- I. That the total amount of finance costs capitalized during a period should not exceed the total amount of finance cost incurred during that period.
- II. That capitalization of finance cost should be suspended during extended periods.
- III. That the capitalization of finance cost should cease when substantially, all the activities that are necessary to get the tangible fixed asset ready for use are complete.
- IV. That in case when construction of a tangible fixed asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalization of finance costs relating to that part should cease when substantially all the activities that are necessary to get that part ready for use are completed.

(C) SUBSEQUENT EXPENDITURE

Regarding this type of cost, AS-10 says:

- I. Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement.
- II. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.
- III. The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value.
- IV. Any addition or extension, which has a separate identity and is capable of being used even after the existing asset is disposed of, is accounted for separately.

FRS-15 has explained, in an elaborate manner, the following circumstances under which the subsequent expenditure is to be capitalized:

- I. Where the subsequent expenditure provides an enhancement of the economic benefits of the tangible fixed asset in excess of the previously assessed standard of performance.
- II. Where a component of tangible fixed asset, that has been treated separately for depreciation purposes and depreciated over its individual useful economic life, is replaced or restored. This standard has explained its above version by citing an example as "a furnace may require relining every five years and for depreciation purpose, an entity has been treating it separately from rest of assets. In this case, subsequent expenditure incurred in replacing or renewing the component is accounted for as an addition to the tangible asset".
- III. Where the subsequent expenditure relates to major inspection or overhaul of a tangible fixed asset that restores the economic benefits of that asset that have been consumed by the entity and have already been reflected in depreciation. Again this view is explained with the help of an example "An aircraft may be required by law to be overhauled once in every three years. Unless the overhaul is undertaken, the aircraft cannot continue to be flown".

OTHER CASES

A. Cost of Assets Received by Way of Gift / Donation:

- a. FRS -15 says that the initial carrying amount of Tangible Fixed Assets received as gifts and donation by charities should be the current value of the assets at the date they are received. Current value here implies the lower of replacement cost and recoverable amount.
- b. Whereas under AS-10, there is no such clause which may guide the measurement of cost of an asset received by way of grant, gift or donations.

B. Valuation of Fixed Assets in Special Cases

It is only AS-10 which considers the following:

- a. In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.
- b. Where an enterprise owns fixed assets jointly with others (otherwise than as a partner in a firm), the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.
- c. Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

(2) VALUATION

This topic deals with the revaluation of the assets and has been considered under following sub-headings:

- Class of assets
- Frequency
- Revaluation basis
- Increase or decrease in value on revaluation

(A) CLASS OF ASSETS

FRS-15 explains the same in the following manner:

- a) An entity has the option of revaluing its tangible fixed assets. However, where such a policy is adopted, it should be applied consistently to all tangible fixed assets of same class.
- b) In those rare cases where it is impossible to obtain a reliable valuation of an asset held outside UK or The Republic of Ireland, the asset may be excluded from the class of assets for the purpose of this paragraph.
- c) However carrying amount of the tangible fixed asset and the fact that it has not been revalued must be stated.
- d) The separate classes of tangible fixed assets that are shown in the formats in companies legislation are:
 - i. Land and building;
 - ii. Plant and Machinery; and
 - iii. Fixtures, fittings, tools and equipment.
- e) These are the broad classes. For the purposes of valuation, entities may, within reason, adopt other narrower classes that meet the definition of class of assets and are appropriate to their business. e.g., land and building may be split into specialized properties, non-specialized properties and short leasehold properties.

AS-10 explains the matter in following words, "Selective revaluation of assets can lead to unrepresentative amounts being reported in financial statements. Accordingly, when revaluations do not cover all the assets of a given class, it is appropriate that the selection of assets to be revalued be made on a systematic basis. For example, an enterprise may revalue a whole class of assets within a unit."

(B) FREQUENCY

FRS-15 considers, "Where a tangible fixed asset is revalued, its carrying amount should be its current value at the balance sheet date. Generally this requirement is achieved by performing a full valuation at least every five years and interim valuation in third year, with an interim valuation in the intervening years where it is likely that there has been a material change in value."

AS-10 is silent on the point of frequency of revaluation.

(C) VALUATION BASIS

Under **FRS-15**, broad classification of assets has been given and for every class, different valuation base is mentioned.

Whereas under **AS-10** it is mentioned, "Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis." No further detail is given.

(D) INCREASE OR DECREASE IN VALUE ON REVALUATION

AS-10 considers, "An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It

sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case, the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease. "

FRS-15 is of the similar view.

(3) DEPRECIATION

According to **FRS-15**, "The fundamental objective of depreciation is to reflect in operating profit, the cost of use of the tangible fixed assets (i.e. the amount of economic benefit consumed by the entity) in the period. Therefore, the depreciable amount (i.e. cost or revalued amount, less residual value) of a tangible fixed asset should be recognized in the profit and loss account on a systematic basis that reflects as fairly as possible the pattern in which the asset's economic benefits are consumed by entity over its useful economic life."

AS-6 defines, "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 the asset. Depreciation includes amortization of assets whose useful life is predetermined.

a. Rates of Depreciation

Rates of providing depreciation are normally based on cost, useful life and residual value of an asset, which has already been explained earlier. Indian accounting standard put certain restrictions on depreciation rates. According to **AS-6**, "The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. 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, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute."

Whereas, **FRS** does not restrict the rates.

b. Depreciation Method(s)

AS-6 describes that there are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straight-line method and the reducing balance method. 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.

a) A combination of more than one method is sometimes used.

b) In respect of depreciable assets, which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

c) Further, **AS-6** governs that the statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets (Schedule XIV). 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, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

d) After considering the above paragraph, we can say that as per Sch XIV of Indian Companies Act, 1956, only two methods are available to a company for providing depreciation viz. Straight Line Method and Written Down Value Method. So one can conclude that as per **AS-6**, a company has a limited choice of two methods only.

e) On the other hand, Sec 205 of Companies Act further allows the companies to opt for method other than SLM and/or WDV but with the prior approval of the central government. But till date, the government has not provided approval even to the companies have sought for the same.

Under **FRS-15**, no restrictions are imposed on the companies while opting for method of providing depreciation. However, it has mentioned the two of the more common methods used viz. Straight Line Method and Written Down Value Method.

c. Change of Depreciation Method

These Standards provide the following views on this matter:

AS-6 explains, "The method of depreciation is applied consistently to provide comparability of the results of the

operations 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 the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed. "

A change in the method of depreciation is treated as a *change in an accounting policy* and is disclosed accordingly.

FRS-15 is of the view that a change from one method of providing depreciation to another is permissible only on the grounds that the new method will give a fairer presentation of the results and of the financial position. Such a change *does not, however, constitute a change of accounting policy*; the carrying amount of the tangible fixed asset is depreciated using the revised method over the remaining useful economic life, beginning in the period in which the change is made.

(4) REVIEW OF ECONOMIC LIFE

Regarding review of economic lives of assets, **AS-6** is of the view that the useful lives of major depreciable assets or class of assets may be reviewed periodically. Where there is revision of the estimated useful life of an asset, the unamortized depreciable amount should be charged over the revised remaining useful life.

FRS-15 in this regard says that the useful economical life of a tangible fixed asset should be reviewed at the end of each reporting period and revised if expectations are significantly different from previous estimates. If a useful economic life is revised, the carrying amount of the tangible fixed asset at the date of revision should be depreciated over the revised remaining useful economic life.

(5) DISCLOSURE

Disclosure means the things, which a company must reveal so as to provide true and fair view of the financial position of the company. Following are the major considerations of different Accounting Standards under study:

As per requirements of **AS-6**, the following information should 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; and
- iii. The related accumulated depreciation.

(a) The following information should also be disclosed in the financial statements along with the disclosure of other accounting policies:

- i. Depreciation methods used and change in method if any; and
- ii. Depreciation rates or the useful lives of the assets if they are different from the principal rates specified in the statute governing the enterprise.

(b) In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

(c) Further disclosure that is sometimes made in financial statements include: revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

FRS-15 requires near about the same type of disclosures viz.

- (a) depreciation methods used;
- (b) useful economic lives or the depreciation rates used;
- (c) total depreciation charged for the period;
- (d) financial effect of a material change during the period;
- (e) reconciliation of the movements separately disclosing additions, disposals, revaluations, transfers , depreciation etc.

FINDINGS AND SUGGESTIONS

From the above discussion, following points broadly come to the notice:

1. That the accounting standards being prescribed in the two countries have certain variations/differences.
2. That such variations/differences may be reconciled in the light of globalization concept.

From the detailed discussion on the accounting standards being followed in two countries, it has been observed that there are certain variations/differences in Indian accounting standards pertaining to depreciation and fixed assets as compared to the standard of United Kingdom. Following are some of the aspects on which Indian standards differ from standards of UK:

1. Choice of depreciation methods;
2. Depreciation rates;
3. Change of depreciation method;
4. Frequency of revaluation;
5. Treatment of assets received as gift/donations; and
6. Disclosure.

1. CHOICE OF DEPRECIATION METHOD(S)

In India, Sch XIV read with sec 205 of Companies Act has been providing guidelines for depreciation. As per Sch XIV, SLM and/or WDV method. i.e. either SLM or WDV method or combination of both methods, are the options available to corporate sector in India, for depreciating its fixed assets. For adoption of **method other than** the above, **prior approval of Central government** is necessary. Whereas in UK's standard, enterprises are free to choose any appropriate depreciation method.

2. DEPRECIATION RATES

In India, the **depreciation rates** prescribed by **Sch XIV** are being considered as the **minimum rates**, which implies that company has to follow these rates even in case if the lives of assets (as per their estimation) are more than those considered under Sch XIV. However, the companies can choose justified higher depreciation rates than prescribed in Sch XIV on the basis of bonafide technological evaluation. For the purpose, no prior approval of central government is needed, however proper disclosure is required. In UK's Standard, no such restriction is made.

3. CHANGE OF DEPRECIATION METHOD

FRS considers change in accounting method as change in accounting estimates whereas, AS-6 treats change in depreciation method as change in accounting policy.

4. FREQUENCY OF REVALUATION

AS-6, no doubt, agrees on revaluation but the standard has not mentioned the frequency of revaluation. However, FRS15 has recommended a full revaluation at least every five years and interim valuation in third year, with an interim valuation in the intervening years where there might have been a material change in value.

5. TREATMENT OF ASSETS RECEIVED AS GIFT/DONATIONS

AS-6 or AS-10 in India has not provided any directions regarding the treatment of cost of assets received as gifts or donations. This implies that the companies may opt for their own treatment in case of assets received as gifts/donations.

SUGGESTIONS

The above facts lead one to the conclusion that more or less the standards under study differ with each other on many grounds. Today, companies in many key industries are confronting increase in worldwide competition. They are responding to this challenge with strategies of globalization. As a result, the leading companies now operate on a global basis with subsidiaries in all important countries or regions. The pressure to globalize is also felt by many small and medium-size enterprises that supply components or specialised services to the giant multinational companies. Further for the globalizing companies, accounting reports are a vital means of internal communication between managers and employees from different national backgrounds. Even though the core concepts of accounting are not very different internationally, differences in rules and in their application hamper internal communication. For example, when one company is incorporated in UK with its subsidiary in India and in both of the countries, as discussed above, there are some differences in accounting standards e.g. the accounting method of the holding company regarding depreciation is, say, double declining method whereas for its Indian subsidiary it has to opt from SLM and/or WDV method(s). This may lead to confusion. Globalization of accounting standards may be taken as a measure of reconciliation of differences amongst various accounting standards in different countries. The use of only one set of global accounting principles would facilitate internal and external communication. In India after the avowed adoption of liberalisation and globalisation as the corner stones of Indian economic policies in early '90s, the accounting standards have increasingly assumed importance

as cross-border raising of huge amounts of capital has also generated considerable interest in the generally accepted accounting principles in advanced countries. As globalisation becomes a reality rather than a slogan, the trading world and international capital markets need to have internationally accepted accounting standards (IAASs) if they are to function effectively. So the solution to the problem of differentiation in various accounting standards may lie in one set of global accounting principles and it is further suggested that the bodies concerned with the standards formulation should come to the forefront and work in this direction. International Financial Reporting Standards (IFRS) may be considered as a ray of hope in this direction. In 2002, the FASB and the International Accounting Standards Board (IASB) reached agreement on a project to eliminate major differences between IFRS and U.S. GAAP. No doubt, this challenge has been more difficult than many expected, but it is important to note that several other major countries (including Japan, Russia, and Australia) have made similar decisions to harmonize their accounting standards with IFRS, now considered the international benchmark.

In India, adoption of liberalisation, privatisation and globalisation has provided the way for multinational companies to enter into Indian corporate sector. After the opening up of the corporate sector, the harmonisation of Indian accounting standards with International accounting standards becomes the need of the hour. However, following amendments in Indian accounting standards concerning fixed assets and depreciation, are proposed for the time being:

1. Any change in depreciation method is being considered as change in accounting estimate by International Accounting standard (IAS) and accounting standards in UK. Where as accounting standards in India have been directing the companies to treat such change as change in accounting policy. It is recommended here that any change in depreciation method shall be considered as change in accounting estimates in Indian standards also so as to keep it in line with IAS and accounting standards in other countries. This may provide the way for formulation of global accounting standards.
2. Today's dynamic world has been experiencing frequent technological advancements. As a result, certain assets become obsolete in a very short period. So it is suggested that useful life and residual value of such assets which are prone to obsolescence may be reviewed at the end of each financial year. This may lead to charging of proper depreciation in books of accounts. For the purpose, the Indian accounting standards, concerning fixed assets and depreciation, may be suitably amended.
3. Since no clear-cut directions in Indian accounting standards, relating to fixed assets and depreciation, are available in case of unusual items like obsolescence, accidents and inadequacy, the companies are engaged in divergent practices regarding the treatment of these items. However, in case of obsolescence, AS-6 only mentions that useful life of a depreciable asset should be estimated after considering obsolescence, whereas it is silent on immediate obsolescence. Since these unusual items are considered as causes for depreciation in accounting theory, so it is recommended that these shall be treated as depreciation in practice also. So in order to restrict divergent practices, clear-cut directions in this regards may be incorporated in accounting standard(s).
4. Indian accounting standards, concerning fixed assets and depreciation, have not provided any directions regarding the treatment of cost of assets received as gifts or donations. So it is recommended that the directions in this regard may be incorporated in the existing accounting standards.
5. Further, regarding disclosures, it is recommended that the Indian accounting standards concerning fixed assets and depreciation shall be in line with IAS and suitable amendments, in such accounting standards in India, should be made.

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