
Accounting Standard-6

Depreciation Accounting - Accounting Standard-6 (AS-6)

Introduction:

Each company adopts its own accounting policy for depreciation. However it is essential that such a policy is disclosed for understanding the financial statements.

The standard for Depreciation Accounting is mandatory and applies to all assets that are subject to wear and tear. Some assets however are excluded from this standard and are treated separately. They include:

- Forest, plantation and similar regenerative natural resources
- Wasting assets like exploration for extraction of minerals, oils, natural gas
- Research and development expenditure
- Intangible assets including goodwill
- Live stock

Land is also not depreciated unless information is available that the same has a limited useful life.

Depreciation:

Depreciation is a charge and indicates the amount of the value of an asset that has been used up. This could happen due to wear and tear, obsolescence due to technology changes or change in market conditions. It is applied systematically each year and as a Non-cash business expenditure.

Depreciable assets should fulfill the following conditions:

- They should be held for more than an accounting year
- They generally have a limited useful life
- They should be held by a company for production or supply of goods or services. They could also be held for rental to others or for administrative purposes. However they should not be held for sale to others.

Useful life is either the period for which the asset is expected to be used by the business or number of production units expected to be generated by the company on use of the asset.

Depreciation is charged every accounting year and is independent of the market value of the asset. It also has a significant impact on the financial results of a company.

The amount of depreciation to be charged in a year depends on the following factors:

- Historical cost of the asset or revised value on revaluation
- Expected useful life of the asset
- Estimated residual value of the asset

Historical cost of the asset is the amount paid or agreed to be paid to bring the asset to its location and make it functional. Hence costs of commissioning or installation form part of such costs. If modifications are made to the asset to enhance its life, such costs are added to its historical costs. So in practice historical cost of an asset may change during its lifetime.

Useful life of an asset is usually lower than its physical life. This may be governed by contracts which limit the use of the asset or company's policy of maintaining assets. Sometimes it is dependent on technology changes in production or demand in the product making the asset obsolete.

When modifications are made to an existing asset to enhance its life, the additional amount incurred is added to the value of the asset and becomes an integral part of the cost of the asset. It is also depreciated at the same rate as the original asset. However if the modification or enhancement is made such that the additions have a longer useful life and can exist independent of the main asset, it is depreciated separately based on its useful life.

Residual value of an asset is estimated at the time of installation of the asset or at the time of its revaluation. If the expected residual value is insignificant, it is treated as nil. A common way to determine residual value of an asset is to compare the asset with similar ones already existing in the market.

Depreciation method & rates:

The methods of depreciation prescribed by the Companies Act, 1956 are the Straight Line Method and Written Down Value. The company is free to adopt any method. The method adopted by a company will depend on:

- Type of asset
- Use of the asset and
- Circumstances prevailing in the business

The Companies Act, 1956 gives the minimum rates for different classes of assets. When the management of a company are of the view that the useful life of the asset is likely to be lower and the applicable rate as per the Companies Act, 1956 may not be appropriate, it can adopt a higher rate for that asset. Further if the asset is of very low value, the entire amount may be depreciated in a year. When a company changes its method of depreciation, it has to recalculate depreciation on the assets from the date it was put into use by the new method adopted and the difference resulting from such change must be disclosed separately.

According to AS-6 guidelines the following must be disclosed in the final accounts:

The method of depreciation adopted by the company must be stated. The gross value of each class of assets and their accumulated depreciation must be disclosed. Rates applied need not be explicitly stated if the rates as per statute have been adopted. If different rates have been adopted, it should be mentioned.

When there is a revaluation of assets, depreciation is charged on the remaining life of the asset and on its new historical cost. If this results in a material change in the depreciation amount, it is necessary to give a disclosure. When an asset is sold, disposed of or discarded, the net surplus or deficiency if material is disclosed.

Most importantly if the company adopts a change in the method of depreciation, it amounts to a change in accounting policy and has to be mandatorily disclosed.

Conclusion:

To summarize, AS-6 is a mandatory standard and applies to most assets that are prone to wear and tear. The Companies Act, 1956 allows 2 methods of depreciation and the rates are prescribed by the Act. A company can adopt any method of depreciation depending on the asset, its use and the business environment. A company can also change the method of depreciation in a year. If a change is made, depreciation from inception of the asset has to be recalculated and the impact disclosed.

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