AccountAble™

Depreciation Accounting – 1 **Issue # 104; Aug-04**; Released: Mar - 05

In this issue

Depreciation since long has been a disputed issue amongst NGOs. Some charge depreciation regularly. Others don't charge any depreciation.

For NGOs that do charge depreciation, there are questions about the rates to be used. Then finally, there is the question of how to account for the depreciation.

These two issues of AccountAble[1] deal with some questions related to depretion: what is depreciation, how to calculate it and finally, how to account for the depreciation that you are charging.

What is Depreciation

When you buy a fixed asset, it has a certain life, over which it can be used. After that time, most probably it will have to be replaced.

For example, a thatched roof hut may last for 5-10 years. A building constructed with RCC[2] may last as much as a hundred years. This happens mainly because of wear and tear. Some assets may be very short-lived, though due to a different reason. Computers grow obsolete very fast.

Charging depreciation is a way of ensuring that fixed assets are not shown at an inflated value in the Balance Sheet. The amount of depreciation is normally charged to Profit & Loss Account. Thus, it also helps in creating a reserve for replacing the assets, when they are worn out.

The concept of depreciation has essentially been developed for business enterprises. Can we apply this concept to NGOs also? There is no definite agreement on this as yet. As stated earlier, some NGOs charge depreciation, others don't.

Depreciation Method

There are two popular methods of depreciating assets. One is called straight-line method and the other is called reducing balance method. How do these work?

1. Straight-line Method

In this method, the amount of depreciation remains the same through out the life of the asset. For example, if you estimate the life to be about 28 years, then you would divide the cost of the asset by 28. This will give you the amount of depreciation for each year.

Mostly, however, people use standardised rates for depreciation. Some common depreciation rates under straight-line method (SLM) are given below:

[1] Issues 104 and 105

[2] Reinforced Cement Concrete

Category	SLM Rate	Life (years)
Buildings[3]	1.63%	58
Plant and machinery	4.75%	20
Office Equipment	4.75%	
Cycles	7.07%	
Motor cars/ motor-cycles, scooters	9.5%	
Motor buses / motor lorries, tractors	11.31%	
Computers	16.21%	6
Furniture and fixtures	6.33%	
Furniture and fixtures used in schools, colleges, meeting halls, welfare centres,	9.5%	
Fishing boats	10%	
Inland boats	3.34%	

These rates have been taken from the Companies Act, 1956[4].

There is another set of rates available in the Income Tax Act, 1961. However, these rates have been designed to give a financial incentive[5] to the assessee. NGOs do not have to pay income tax. Therefore, these rates are not as suitable for our purpose.

The SLM rate is applied on the original cost of the asset each year. The original cost is also called gross block. The following example shows how this is done. In this case, the original cost of the computers is Rs.1,00,000:

Year	Calculation	Depreciation
1	100,000 x 16.21%	16,210
2	100,000 x 16.21%	16,210
3	100,000 x 16.21%	16,210
4	100,000 x 16.21%	16,210

2. Written-down Value Method

In this method, the rate is applied on the net value of the asset. What does net value mean?

Suppose, the original cost of the computers is Rs.1,00,000. In the first year, the depreciation will be calculated using this as a basis. If the rate is 40%, then the depreciation comes to Rs.40,000. Net value of the asset will now be Rs.60,000. Next year, the depreciation will be calculated on this (Rs.60,000), as shown below:

Year	Calculation	Depreciation
1	100,000 x 40%	40,000
2	60,000 x 40%	24,000
3	36,000 x 40%	14,400
4	21,600 x 40%	8,640

Rate for written-down value (WDV) method are higher than those under the straight-line method. These are given below:

Category	WDV Rate	Life (years)

[3] Including roads, culverts, wells, tube-wells

[4] Schedule XIV

[5] In the form of reduced taxable income, by specifying higher rates for certain items such as energy-saving devices

Category	WDV Rate	Life (years)
Buildings[6]	5%	
Plant and machinery	13.91%	
Office Equipment	13.91%	
Cycles	20%	
Motor cars/ motor-cycles, scooters	25.89%	
Motor buses / motor lorries, tractors	30%	
Computers	40%	
Furniture and fixtures	18.1%	
Furniture and fixtures used in schools, colleges, meeting halls, welfare centres,	25.88%	
Fishing boats	27.05%	
Inland boats	10%	

Capital Fund

This question is closely linked with how you acquired and accounted for the fixed assets in the first place. Most of the fixed assets are purchased out of project grants. Some assets are purchased from own funds also. In some cases, the assets are donated to the NGO. Let us, therefore, look at the accounting entries for these transactions:

1. Out of Project Grant

When the assets are purchased, following entry is passed (Vr.1):

[6] Including roads, culverts, wells, tube-wells

Lok Jagran Manch	Vr.1	1-Apr-05
Dr. Furniture A/c - CRY		10,100
Cr. Bank A/c		10,100
Tables and chairs purchased for meeting hall from Sh. XYZ		

This will be reported as utilisation to CRY. However, this amount can not be shown in the Income & Expenditure Account, as it is not an expense. Where will it be shown then? On the Assets side of the Balance Sheet.

Further, for a properly balanced presentation, a Capital Fund should also be created on the Liabilities side (Vr. 2):

Lok Jagran Manch	Vr.2	1-Apr-05
Dr. Grant A/c - CRY		10,100
Cr. Capital Fund A/c		10,100
Transfer of funds against purchase of tables and chairs from CRY Grant A/c to Capital Fund A/c		

Based on the above two entries, the Balance Sheet will look like the one shown below:

Liabilities	Rs.	Assets	Rs.
General Fund	15,000	Furniture	10,100
Capital Fund	10,100	Other assets	15,000
Total	25,100	Total	25,100

What is the purpose in creating the Capital Fund? Well, if we did not, then the Income & Expenditure Account would show an extra surplus of Rs.10,100. This would then get transferred to the General Fund and be shown as below:

Liabilities	Rs.	Assets	Rs.
General Fund	25,100	Furniture	10,100
		Other assets	15,000
Total	25,100	Total	25,100

This presentation may cause confusion that so much money is available in the General Fund for spending on various purposes.

Therefore, creating a Capital Fund to counter-balance the purchase of fixed assets is considered better.

2. Out of Own Funds

When the assets are purchased out of own funds, the same entry is passed as shown in Voucher 1. However, after this a question arises. Should we create a Capital Fund for these assets also? After all, these assets have not been purchased out of a grant. These have been purchased out of General Fund.

Let us see what happens if we do not create a Capital Fund. The Balance Sheet will look like the following:

Liabilities	Rs.	Assets	Rs.
General Fund	25,100	Furniture	10,100
		Other assets	15,000
Total	25,100	Total	25,100

We have already discussed this presentation and how it would cause confusion.

A better alternative would be to create a Capital Fund as below (Vr. 2A):

Lok Jagran Manch	Vr.2A	1-Apr-05
Dr. General Fund A/c		10,100
Cr. Capital Fund A/c		10,100
Transfer of funds against purchase of tables and chairs from General Fund A/c to Capital Fund A/c		

What would the Balance Sheet look like?

Liabilities	Rs.	Assets	Rs.
General Fund	25,100	Furniture	10,100
Less: T/f to		Other assets	15,000
Capital Fund	-10,100		
Cl. Balance	15,000		
Capital Fund	10,100		
Total	25,100	Total	25,100

Continued in AccountAble 105...

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Published by AccountAid India, New Delhi; Printed at Chanakya Mudrak Pvt. Ltd., New Delhi. Ph.: 5142 0316, 2592 7951