AccountAble™

Depreciation and Its Accounting - 2 **Issue 105 for Sep-04**; Released: Mar - 05

In this issue

Continued from AccountAble 104...

In the previous issue, we have discussed depreciation and methods of calculating depreciation. We are now discussing the method of creating a Capital Fund. How do we create a Capital Fund, when assets have been donated?

3. Donated Assets

Mostly NGOs purchase assets out of funds provided from a grant or from own funds. But sometimes, physical assets are donated to the NGO. In such a case, no cash or bank payment is made. Mostly the transaction remains unrecorded.

Is this wise? If the asset remains unrecorded, how will the NGO fulfill its custodianship function? How will it ensure that the asset is utilised effectively and efficiently? How will it make sure that asset is not misappropriated? The accountants and auditors will not be able to play any role in this, if the asset remains unrecorded.

Issues around Recording and Valuation

The ICAI has recommended that such assets should be recorded in the books of account[1]. However, according to ICAI, the entry should be for a nominal value[2] only.

On the other hand, the American view[3] is that such assets should be recorded at a fair value[4].

Why this variation between American and Indian thinking on this issue? You see, under American tax law, donations in kind are tax-deductible. To get a deduction from tax, you have to estimate the value of the asset also. Therefore, valuation of donated assets is not a difficult or controversial issue.

This is not so in India. Here, donations- in-kind are not recognised under Income Tax Act. Therefore, the procedures for valuing these have not developed.

However, India has a long tradition of donating materials and assets. These practices have remained alive, and are widely prac-

[1] Pages 69, 76, discussion on applicability of AS 10 and 12; Technical Guide on Accounting and Auditing in Not-for-Profit Organisations; Institute of Chartered Accountants of India, New Delhi; 2003

[2] For example, Rupee one.

[3] Page 295, Wiley Not-for-Profit GAAP 2001; Richard F. Larkin and Marie DiTommaso; John Wiley & Sons, New York; 2001

[4] Prevailing at the time of donation

tised even today on special occasions such as *Makar Sankranti*[5] (mkr s³aiNt).

Recommendation

Therefore, considering Indian giving practices, it is important to encourage valuation of donations-in-kind, including donations of fixed assets[6]. This will also help us get a better idea of the resources that are raised in this manner.

Accounting

Let us now look at the accounting issues. At the time of receiving the asset, the following voucher should be made (Vr. 1A):

Lok Jagran Manch	Vr.1A	1-Apr-05
Dr. Furniture A/c		10,100
Cr. Donations-in-Kind: Materials A/c		10,100
Tables and chairs donated for meeting hall by Sh. ABC		

Now we should also create the Capital Fund as in earlier cases (Vr. 2B):

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

Why are we debiting General Fund here? Because this donation is not an ear-marked donation such as a project grant. It would help increase the General Fund. Therefore, we are adjusting the General Fund.

An alternative would be to credit the donation directly to Capital Fund in voucher 1A itself. However, this would mean that the transaction would not show up in the Income & Expenditure Account. Therefore, it makes better sense to route it through the Donations-in-Kind account.

Depreciation Accounting

We are now ready to look at the entries for depreciation. After you have calculated the depreciation, you have two options for passing the entries.

1. Through the Income & Expenditure Account

Ideally, this method should be used where you have not created a Capital Fund at all. In such cases, the ultimate effect of depreciation will be transferred to the General Fund.

Lok Jagran Manch	Vr.3	31-Mar-06
Dr. Depreciation A/c		1,010
Cr. Furniture A/c		1,010
Depreciation on furniture for 04-05 @ 10%		

Remember also that if you did not create a Capital Fund, then the value of your fixed assets is being held in the General Fund only[7]. Therefore, it is proper that the General Fund should get adjusted for the depreciation also.

For those with a Capital Fund

Can this entry be used for those who have created a Capital Fund? Yes, they can also use it.

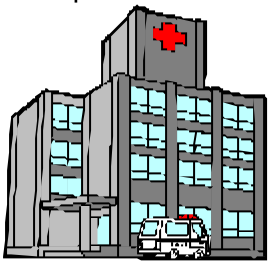
---

[5] When the Sun's position (vis a vis the Earth) moves into the Northern Hemisphere

[6] For more on this, see AccountAble 30: Contribution in Kind, available at www.AccountAid.net

[7] In such cases, the capital portion of a grant is also credited to Income & Expenditure Account. As a result, the surplus is inflated by the amount spent out of the grant on purchasing fixed assets during the year. This surplus is eventually transferred to the General Fund or a similar fund.

However, in such cases, the Capital Fund will not reduce simultaneously with reduction of fixed assets base. Therefore, the Capital Fund will gradually become more like a hidden reserve, which can be used to acquire replacement of old assets.



This approach will be ticularly relevant for those NGOs, which have any business-like activities. Examples include hospitals, schools, income-generation projects, etc.

2. Directly to the Capital Fund

Suppose you have created a Capital Fund but don't plan to use it for replacement of old assets. Then a better option for you will be to consider the following entry (Vr. 3A):

Lok Jagran Manch	Vr.3A	31-Mar-06
Dr. Capital Fund A/c		1,010
Cr. Furniture A/c		1,010
Depreciation on furniture for 04-05 @ 10%		

This entry will reduce both, the Fixed Assets and the Capital Fund, by the same amount. However, the transaction will not show up in the Income & Expenditure Account at all. Neither will it be reported in the Receipts & Payments Account.

Is this right? Should we not report Depreciation in the Income & Expenditure Account? To understand more about this, let us see why depreciation is charged at all.

Why Depreciation?

Structured use of depreciation started around 19th century, with the emergence of modern joint-stock company. At that time, only a few companies were charging depreciation. Some would not charge any depreciation. This resulted in higher book profits. They would then declare huge dividends. This kept the share price high.

When complaints were received from some investors about this practice, the regulators passed a law[8]. The law provided that no company could declare a dividend without providing for depreciation on its assets. This law is still contained in section 205 of the Companies Act, 1956.

Under the Income Tax Act, an allowance for depreciation was introduced on the demand of the business assessees. This allowance is contained in section 32 of the Income Tax Act, 1961.

However, in the modern accounting profession, the position is quite clear. Depreciation is an essential charge if you want to match revenue with expenditure.

Thus, we can see three streams of thought regarding relevance of depreciation:

1. Preventing distribution of fixed assets as dividend;
2. Ensuring lower tax on income;
3. Matching revenue with expenses.

---

[8] In England, the Joint Stock Companies Act of 1844 required depreciation accounting for railroads, mining, and manufacturing (although the concept of depreciation possibly dates back to Roman times).

The first two are obviously not relevant to NGOs. However, the third makes more sense. Charging of depreciation will help bring out the results of the year more clearly.

3. Best of Both the Worlds

If this thinking appeals to you, then you could pass the following set of entries:

Lok Jagran Manch	Vr.3	31-Mar-06
Dr. Depreciation A/c		1,010
Cr. Furniture A/c		1,010
Depreciation on furniture for 04-05 @ 10%		

This entry will lead to charging of depreciation to the Income & Expenditure Account. After this, you could pass another entry (Vr. 4):

Lok Jagran Manch	Vr.4	31-Mar-06
Dr. Capital Fund A/c		1,010
Cr. Income & Expenditure A/c		1,010
Capital Fund adjusted for Depreciation for 04-05		

These two entries will ensure that:

- Depreciation is disclosed in the Income & Expenditure Account.
- Capital Fund is adjusted for charge of depreciation.

In this case, the Income & Expenditure Account will look as shown below:

Expenditure	Rs.	Income	Rs.
Expenses	15,000	Donations	15,000
Depreciation	1,010	T/f from Capital Fund	1,010
Total	16,010	Total	16,010

The Balance Sheet will appear as below:

Liabilities	Rs.	Assets	Rs.
General Fund	15,000	Furniture	9,090
Capital Fund	10,100		
Less: T/f to Income & Exp. Account	-1,010	Other assets	15,000
Cl. Balance	9,090		
Total	24,090	Total	24,090

Related AccountAble Issues:

30: Contribution in Kind

What is AccountAble: Each issue of 'AccountAble' covers a different topic related to NGO regulation or accounting and is mailed to about 2,700 persons in NGOs, Agencies and audit firms. AccountAid encourages reproduction or re-distribution of 'AccountAble' in workshops or NGO newsletters for non-commercial use, provided the source is acknowledged.

AccountAble in Hindi: Ak%{qbl ihNdl m'loa-yag' k nam s %plBx h,

Interpretation of law: Interpretation of law given here is of a general nature. Please consult your advisors before taking any important decision.

AccountAble on the Web: All the past issues of 'AccountAble' are available on our web-site www.accountaid.net.

AccountAid Capsules: Short items of information on NGO accounting and related issues. To subscribe, send e-mail to accountaid-subscribe@topica.com.

Questions?: Your questions, comments and suggestions can be sent to AccountAid India, 55-B, Pocket C, Siddharth Extension, New Delhi-110 014; Phone: 011-2634 3128; Ph./Fax: 011-2634 6041; e-mail: accountaid@vsnl.com; accountaid@gmail.com

Published by AccountAid India, New Delhi; Printed at Chanakya Mudrak Pvt. Ltd., New Delhi. Ph.: 5142 0316, 2592 3951