CHAPTER 7

TAX POLICY AND ITS IMPLICATION ON DEPRECIATION.
Introduction:

The finance is the main element for the success of industrialisation, because finance is the oxygen of the industry.\textsuperscript{1} It is not limited with the acquisition of finance, as capital, but also its management in the business is important. Dealing of finance by the business unit can be very well understood from its yearly financial statements. The financial statements of an enterprise generally depict major part of funds blocked in fixed assets.\textsuperscript{2} The assets are acquired by the business because of their usefulness to the enterprise.\textsuperscript{3} The term fixed assets is used to describe long lived assets acquired for use in the operation of the business. They are not meant for resale to customers.\textsuperscript{4}

The cost of fixed assets is recorded on the books of the company because future periods are benefited.\textsuperscript{5} Here one thing must be remembered that "when capital is invested in any kind of business enterprise, it is sure to change in value as

\textsuperscript{1} Loknathan P. S., "The changing structure of Industrial Finance", The A. D. Shroff Memorial Trust, Bombay, (1969), p-6
\textsuperscript{4} Gupta, R. L., Advanced Accountancy, Sultan Chand and Sons, New Delhi, (1981) p-21
\textsuperscript{5} Mccullers Levis D and Daniker, Retmond P. Van, Introduction to Financial Accounting, Melville Publishing Company, Los Angeles, California. (1975), p-235
times goes on. Otherwise it can be said that "except for land, all other assets have a limited economic life spanning more than one accounting period." During this limited economic life the "fixed assets can be imagined as a bundle of future services to be used by the owner over a period of years." So "a part of the asset cost must be expensed in each accounting period to recognise the use of these assets in each period for generating revenues and hence income. The accounting terminology for this gradual expensing of the cost of fixed assets is called depreciation." In different ways the depreciation, "as the term used in accounting is nothing more than the expiration of a plant assets quantity of usefulness and the recording of depreciation is a process of allocating and charging the cost of this usefulness to the accounting periods that benefit from the asset's use."

Need For Depreciation:

It is very important to know why the business firms calculate the depreciation and what is the purpose of providing depreciation?

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First, the assets are purchased for their use in the business to earn profits.\textsuperscript{11} So the businessman is interested to calculate, the net profit earned. It is possible only when all costs of earning revenues have been properly charged against them.\textsuperscript{12} So the need for depreciation is important because to decide what part of the gross profit is to be distributed to the owners of the business.\textsuperscript{13} Depreciation plays a major role to calculate divisible profit because under section 205 of companies Act, 1956 the provision for depreciation is compulsory and generally no company is allowed to pay dividend without providing for depreciation. Secondly, depreciation is considered as an element of cost of a product.\textsuperscript{14} So it is necessary to include depreciation in order to determine the cost of production. While selling price is fixed on the basis of cost of product, the price fixed would be lower, if depreciation is not taken into account, resulting in loss to the manufacturer.\textsuperscript{15} Naturally it can be said that "a significant element of cost is ignored"\textsuperscript{16}. Therefore, the objective of providing depreciation is to give an accurate cost of production, which is to be charged to the consumers.

\textsuperscript{13} Lewis, Arther, W., "Depreciation and obsolescence as Factors in costing" (Ed) by J. L. Meij, Depreciation and Replacement policy, North Holland Publishing Company, Amsterdam, (1961), p-17
\textsuperscript{15} Prasad, R. D., (1979) op. cit., p-6
\textsuperscript{16} Panigrahi, J. op. cit. p- 73.
Thirdly, to preserve the capital assets of the company, it is necessary to charge depreciation. In the annual report of TISCO it is said that "... the ideal objective of depreciation is considered to be recovery each year of sufficient number of current monetary units to be equal to that year's capital consumption in terms of original monetary units. If the depreciation will not be provided the profit will be overcasted. At the time when profits are withdrawn by the shareholders, much of the capitals, representing the cost of the assets have been withdrawn. So it is rightly said that the erosion of owner's capital can not checked without the measurement of depreciation.

Fourthly, in order to compute tax liability the need for computation of depreciation is important. Because depreciation is a tax-deductible expense, it furnishes a business with a tax shield. So the need for measurement of depreciation is important. Its importance was not felt until the Government, through its tax policy levied an income tax on the business income.

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Fifthly, computing depreciation is to make sure that all deterioration of the wasting assets are fully restored before any profits are declared. It is a means to accumulate funds to replace the assets when its useful life is over. So depreciation charged not only helps to replace the asset when its useful life is over but also helps to finance for the expansion and diversification of the business. Because "in course of time due to rapid and frequent technological innovations, replacement takes place in the shape of expansion and diversification."

Lastly, the objective of the charging depreciation is that, it should result in carrying forward only that part of asset which represents the unexpired cost of expected future service. Other way, it will decide how much to buy or sell the asset in the second hand market.

**Historical Background of Depreciation:**

While it has always been a practice to depreciate physical assets, a realisation of the need to do this from a financial point of view did not arise until the beginning of the industrial revolution since an industrial society is far more cognizant of the depreciation of machinery than an agricultural society.

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Prior to 1913, depreciation was taken for not usually depending on profits available to absorb it. After 1913, it has been taken for both books and tax returns.  

The need to keep plant and equipment as modern as possible is a most pressing one in a competitive economy. The post-war period has been one of rapid change for most companies, necessitating replacement of worn-out equipment, modernisation to take advantages of technological progress and acquisition of new facilities to accommodate expanded volume. The need to set aside specific amounts from the replacement of plant, equipment and other fixed assets was felt when the Government, through its tax policies, levied an income tax on business. Once this tax was in operation, it was necessary to make a careful deduction of all expenses before income or profit is determined and depreciation or wear and tear on equipment is one of these expenses.

Later a proper and regular existence of depreciation came into sight and continued till today.

**Importance of Depreciation:**

The modernisations and upkeepment of plant and machinery and other fixed assets is an extremely important function of the corporate management. It is essential to profitable operations of an enterprise. This has always been necessary,

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but today it is much more urgent since the pace of competition, both domestic and foreign, has been stepped up appreciably because of the liberalisation policy adopted by the Government.

The tremendous investment in depreciable property and an increasing amount being poured in every year, depreciation has become a very sizable part of the total cost.\textsuperscript{28} As it has a great part in the total cost, proper care must be taken to manage efficiently. It makes the importance of depreciation, significant on the business fields. According to Leake "it must be possible to ascertain the annual profits of the industry with such degree of accuracy as shall exclude the irregular and wholesale guess work at present prevailing.\textsuperscript{29} Depreciation has a direct relationship for ascertaining the accurate profit of the business. Again it can be said that the importance of depreciation is further increased in the present world because of the changing nature of countries, towards the industrialisation. The need for replacement of asset and also for capital budgeting\textsuperscript{30} depreciation plays a great role.

\textsuperscript{28} N A A Bulletin, Battista George L. and crowning, Shield Gereld. R., op. cit p-21.
\textsuperscript{29} Leake, P. D., Quoted in "Depreciation and its Implications as source of Fund Under the changing price level" by G. S. Panda in Orissa Journal of Commerce, Sambalpur (1974) p-9.
Depreciation and its Related Problems:

The definition of income or profit for tax purposes is mainly based on the accounting practice on the one hand and the administrative limitations on the other. Profit or business income is the difference between the costs of producing a certain quantity of goods and the revenue produced by selling these goods. Costs of production may be divided into two main categories namely capital expenditure and current expenditure. The distinction between these two types of spending is purely one of time and there is no sharp or fundamental distinction between them. While the benefit accruing from current expenditure is exhausted during the accounting period in which the expenditure takes place. But, the benefit accruing from capital expenditure is prolonged beyond the current accounting period. The need for the distinction arises out of the necessity for computing figures of profit for relatively short periods of time, such as a year, for tax purpose. When this has to be done account has to be taken of the fact that, capital expenditure is not entirely a cost of producing goods for that period. Therefore, capital expenditure has to be spread over a number of accounting periods for providing a true and fair impression of business income. The distinguishing feature of capital expenditure, therefore, is that it has to be spread over a number of accounting periods. The problem of the ultimate taxable income could be solved only by the proper valuation of the current assets and the fixed assets (capital goods) used in the
production of commodities. The valuation of the current assets does not pose many problems as to the valuation of the fixed assets.

The capital goods used in the production of commodities naturally wear out. Invariably, owing to the passage of time, the equipments used become obsolete. Therefore, the extent of wearing out, obsolescence and depletion depending upon the nature of the business should also be included in the current costs of production. As William Vickrey correctly says, "depreciation is deducted in order to permit the tax payer to recover intact and free from income-tax his capital investment in plant and equipment. In principle depreciation should reflect the decrease in the value of the capital arising from weathering, wear and tear, exhaustion of useful life and obsolescence."\(^{32}\)

In calculating the depreciation allowances, the management is confronted with various problems. Firstly, the management has to decide the period over which the asset will be in use and providing services. Assets have a limited economic life for two main reasons. On the one hand they deteriorate through actual wear and tear in the process of production. The second group of reasons for a limited life is obsolescence; technological development may occur which makes the cost of operating a particular asset uneconomical, or there may be a shift in the demand for the product for the production of which the asset was purchased.

Further the inadequacy of tools to measure the amount of destruction makes it difficult for the management to estimate at all exactly the economic life of an asset and, therefore, to decide the period over which it has to be depreciated.

There is yet another problem of valuation with regard to durable assets. Seen from the point of view of costing, depreciation gives rise to evaluating the used services of the assets. For the Balance sheet it is necessary to evaluate their non-used services. Every time for the purpose of preparation of financial statements, it is necessary to evaluate the services still available in the assets. The profit figure, too, is affected by the way in which these services are evaluated.

The third aspect of depreciation problem is the determination of the time, when the asset must be replaced. Though there will always be a time when the total value of the asset eventually deducted by the value of the residuum, its scrap value, is totally written off, it is clear that it is not sure that replacement has to take place at that very moment. Thus, this problem can not be automatically solved by application of a depreciation system that seems to be adequate at the time it was chosen.

Finally, by calculating depreciation costs and by selling the product at a price which includes an allowance for depreciation an amount for replacement is gradually earned. The management can only hope that at the time the asset is put

out of use, an amount necessary to finance replacement is at its disposal. However, in practice this is not often realised. Therefore, depreciation gives rise to the problem how to get the means for re-investment.

From the above discussion, it is clear that the above problems arise only in a dynamic economy with changing prices and production techniques. In a static economy depreciation and replacement do not give rise to any problem except that of choosing the adequate depreciation system. The asset can be replaced at the moment, which could be predicted in advance and the necessary means for re-investment could be made available.

The dynamic character of our economic life forces us to consider the problem around the depreciation phenomenon separately. Economic problem arise from the fact that it might be rational to put aside means of production whose stock of services is not totally exhausted and, moreover, that there are different alternatives of replacement of an instrument that has become obsolete. It need not always be replaced by an identical one. The economic replacement is caused by the fact that economic life time is shorter than physical. Therefore, it would not be fair to say that the depreciation system must be based on economic lifetime and that an asset can never be replaced by an identical one.

Further in considering whether or not to replace a particular asset the first thing to be considered is the future market or revenue prospect. The next thing to do is to make estimate of the operating cost of production (including repair and
maintenance expenditure) with the existing stock of capital and with the proposed new capital. The next stage is to lay down the rate at which the new proposed capital expenditure is to be depreciated and the minimum return to be expected on the capital.

In highly speculative ventures where the economic life of the assets is shorter than physical life, then the economic life has to be decided by the depreciation period. The more risky the venture is and the greater the gap between physical and economic life, the higher is the depreciation rate. Similarly, with the required expected return on capital, the more risky the venture, the greater the possibility that the capital will be lost, the higher the minimum rate of return that will be necessary of return that entrepreneur to invest\textsuperscript{33}.

According to W. L. Hearne,\textsuperscript{34} depreciation charges are an important cost of production. Therefore, certain considerations are valid which might not necessarily be true where they are merely allowable deductions from gross income. Mr. Hearne suggests that the recovery of the investment should be made against taxable income during the useful life of the investment and he believes that depreciation should be a financial rather than a physical consideration. In considering the advantages and disadvantages of replacing a given piece of asset or

\textsuperscript{33} Walker, D. "Depreciation Problem And Taxation" (Ed) by Meij, J. L., in "Depreciation and Replacement Policy", (1961) op. cit. p-151.

\textsuperscript{34} Hearne W L., "Depreciation, Depletion, and Research and Development Costs", In How should Corporations be Taxed? Symposium conducted by the Tax Institute, December, Tax institute INC. New York (1946) pp-152-55
of installing a more or less capitalistic process, calculation of both capital as well as current cost of production are necessary if wise and economic decisions are to be taken.

**Depreciation Allowance:**

In business taxation, in addition to the recovery of current cost, the recovery of capital cost representing the costs of capital assets employed in production, namely, plant and machinery, office equipment and building, has to be allowed for. However, the recovery has to be spread over a number of years during which, the value of those assets may be said to gradually depreciate through wear and tear and through obsolescence. Thus, in computing net profits for a year, an appropriate reduction from the gross receipts on account of depreciation of capital assets has to be made.

A depreciation system should try to provide depreciation for tax purposes corresponding as closely as possible to economic depreciation, which takes into account the wearing out of assets as well as obsolescence. If the actual depreciation granted deviates from economic depreciation, effective tax rates will vary between different assets and for the same kind of asset, over time. However, an accurate measurement of economic depreciation is technically very difficult and an attempt to arrive at it would create several administrative problems. Therefore, certain rules, which are considered reasonable, are generally applied. These relate to: a)
the measurement of cost; b) the period over which depreciation should be spread; 
and c) the percentage of the cost to be allowed to be recovered every year.

The calculation of depreciation on capital assets is crucial for the determination of taxable income. It is of course not possible to measure exactly the 'true' economic depreciation in the value of an asset every year, because that would depend on many changing factors and there is no measurable manifestation of the degree of depreciation. However, one could attempt at deriving an approximation to true economic depreciation by adopting a formula for the annual depreciation charge that would enable the recovery of the appropriate amount of money by the end of the useful life of the asset.

The appropriateness of the annual depreciation charge may be considered from two angles: tax equity and the interest of the national economy. From the point of view of tax equity, there should be no under or over-statement of profits or income from business. This result may be said to be achieved, if the annual depreciation allowed enables the investor to recover in real terms the original sum of money expended on the acquisition of the asset, by the end of its useful life. From the point of view of the national economy, the sum of annual depreciation charges made available during the period of the useful life of the asset should be sufficient to enable the purchase of a new asset to replace the old one, as the latter ends its service life, so that the economy maintains intact the capital stock already build up. If prices remain stable, both the above-mentioned objectives could be
achieved by taking the original or historic cost as the basis for depreciation and enabling the producer to recover it over the period of the useful life of the asset concerned. Traditionally, the basis of calculating depreciation under the income tax law has been the original or historic cost of the asset. This practice is in consonance with the accounting convention that the cost of a capital asset should be spread over its useful life in a reasonable and systematic fashion. Problems arise because prices do not remain stable. In fact, there was a significant spurt in capital goods prices during the seventies and even later. Hence, there was a persistent demand that the basis of depreciation should be changed from historic cost to replacement cost, so that the producers would be able to provide adequate replacement for assets that are getting worn out: historic cost depreciation would simply not provide sufficient funds for replacement. It is, however, not easy to measure or estimate asset wise replacement cost because of divergent price trends. In any case, while the depreciation allowance has to be availed of during the period of use of an asset, the cost of replacement will be known only at the time of replacement. In view of this only a broad adjustment could be provided for taking care of the rise in the prices of the assets. The adjustment has taken the form of accelerated depreciation or higher depreciation allowances.

Under the Indian income tax the historic cost has been the basis of granting depreciation as in most other countries. The depreciation regime was characterised by provisions for "normal" depreciation of the basis of historic cost and for several
other additional allowances, partly to take care of inflation and partly to boost investment (presumably) and again partly to take care of the particular circumstances of given groups of tax payers. The major type of allowances provided under the Indian income-tax Act 1961, prior to the assessment year 1988-89, were: normal depreciation, extra shift allowance, additional depreciation, terminal or balancing allowance and rehabilitation allowance (some of these were tailor-made for some or the other category of assesses). When the Economic Administration reforms commission (EARC) considered this matter in 1982-83, all these allowances were in force. Not only were there several types of allowances, but the rate of normal depreciation also varied as between classes of assets. The attempt at calibrating the rates of normal depreciation to match the presumed period of service life of different types of assets and the introduction of a number of allowances to serve various objectives led to much avoidable complexity and added significantly to the difficulties of assessing business income. The complexity in the system of depreciation arose both from the additional allowance, confined to some types of assesses or some types of assets, and from the multiplicity of rates of the normal depreciation allowance. Also, often the grant of an allowance was made conditional, such as on whether the plant was installed after a particular year, whether the year concerned was the first year or the second year of installation and what the intensity of the use of the assets was. Depreciation was calculated in respect of each capital asset separately and not in respect of blocks of assets. This
required elaborate book-keeping and the entire process of checking by the assessing officer was time-consuming. Obviously, the greater the differentiation in rates according to the date of purchase, type of assets, intensity of use, etc., the more desegregated had to be the record keeping. Moreover, the practice of granting a balancing allowance or levying a balancing charge, as the circumstances warranted, necessitated the keeping of records of depreciation already availed of, by each asset eligible for depreciation. There was no doubt that the then prevailing system of depreciation needed to be drastically simplified.

To conclude depreciation as a source of fund is a controversial issue. Accountants do not consider depreciation as a source of fund. According to them it is a non-cash book entry and the fund flow from operation remains unaffected irrespective of the magnitude of depreciation. Thus, if depreciation is increased, the net profit falls, but funds generated through operation remain unchanged. However, the financial managers consider depreciation a source of fund. According to them, depreciation amount is set aside out of the stream of revenues received by a firm. Funds so accumulated necessarily constitute a source of fund. Fund flowing in through depreciation used to finance working capital needs and for modernisation and expansion programme of the firm. But in actual practice the fund generated by way of depreciation is inadequate for replacement. There are two main factors, which are responsible for this inadequacy. These are price level changes and the rapid advancement of science and technology.
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As in many other countries, depreciation under the Indian Income-Tax Act is allowed as a percentage of the historical capital cost of the asset. The replacement cost method of allowing depreciation has not found favour in many countries including India. It is because of the fact that it is not easy to measure asset wise replacement cost because of divergent price trends and the cost of replacement is known only at the time of replacement. But the depreciation allowance is availed of during the period of use of the asset. Thus, broad adjustment should be provided for taking care of the rise in price of the assets.