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Effects of Restriction on Use of Depreciation Method in Income Tax Act as Compared to Companies Act in the Industry

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ABSTRACT

Despite different methods of depreciation calculation being available, when calculating depreciation for tax purposes a company must use a method being made mandatory by the Income Tax Act. In India the Companies Act allows the depreciation calculation by two methods Straight Line method and Written Down Value where as the method allowed by IT act is WDV. Choice of depreciation method has impact on taxation and overall efficiency and profitability of the firm.

The paper discusses the effects of these limitations and variance in depreciation methods by two important regulating authorities on the overall performance of the industry. The paper also analyze the possible outcome of the synchronization of methods in IT Act and companies Act, the views and perceptions of chartered accountants in changed scenario. The need to synchronize the methods of depreciation and benefits to allow other methods are also examined in the conclusion.

KEYWORDS : depreciation method, Income tax Act, Company Act, Fair value, IAS

Introduction:
Tracking Profit and Loss is paramount to the success of any business. Assets are the most essential for any business. Some assets like buildings, equipment, and vehicles can be depreciated while other assets like cash, bonds, and inventories are not depreciated. Any business using tangible assets may incur costs related to those assets.

Depreciation: A method of allocating such net cost to those periods expected to benefit from use of the asset. The reduction in value of an asset over the course of its useful life is depreciation.

The cost of an asset allocated, as depreciation expense, is recognized by businesses for financial reporting and tax purposes. Methods of computing depreciation vary between asset types within the same business and for tax purposes. These is specified by law or accounting standards, which may vary by country. The Depreciation expense is reported on the income statement.

In accountancy, **depreciation** refers to two aspects of the same concept:

The decrease in value of assets (Fair value depreciation), and

The allocation of the cost of assets to periods in which the assets are used (depreciation with the matching principle).

Depreciation Calculation Methods are:
Base Method:

- Straight Line Method (SLM)
- Written Down Value Method (WDV)
- Multi Level Method
- Period Control method
- Depletion Method of Depreciation (WDV)
- Units of production Method

Perhaps the most accurate depreciation methods are those that are tied to actual asset usage (such as the units of production method), though they require much more extensive record keeping in relation to units of usage.

Tax Method:
Methods of computing depreciation, and the periods over which assets are depreciated, vary between asset types within the same business and may vary for tax purposes. When calculating depreciation for tax purposes, company must use a method being made mandatory by the TAX department. Different methods are allowed by respective Internal Revenue Service (IRS) in different countries. SLM is the most popular method of depreciation in U.S. however DDB method is also used. Different other methods are used in European countries. Some countries do not recognize the declining balance method and the SLM is the only method for the depreciation of assets

In India, the methods and rates for depreciation are governed by law under the Companies Act, 1956 and the Income Tax Act. The WDV method is mandatory by Indian Income Tax department. However in India, as per Companies Act, two methods of depreciation SLM and WDV methods are allowed for companies under ROC.

General rules of Depreciation in IT:
Who can claim depreciation?
Depreciation can be claimed by a 'legal owner' (tax payer,) under defined conditions if the depreciable asset is used during the year for the purpose of business and profession;

How depreciation is calculated as per Income-tax Act?
Depreciation as per Income-tax Act is calculated on block of asset basis and as per method prescribed by the IT rules.

IAS 16, states that, "the depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity and that appropriateness of the method should be reviewed at least annually in case there has been a change in the expected pattern."

Rates of Depreciation under Companies Act 1956:
As per Companies Act 1956, depreciation is computed using either the straight-line method or the written-down value method and are specified in Schedule XIV of the Companies Act' 1956.

Modifications of Companies Act 1956 and 1957 as per Companies Act 2013:
Any method WDV or SLM can be used.

Schedule – II contains a list of useful life according to class of assets; the useful life of asset shall not be taken longer than prescribed in this schedule.

Residual value should not be taken more than 5% of cost of asset.

Useful life of assets is to be disclosed only when it is taken different from Schedule – II

For assets in which NESD is mentioned in Schedule – II, the depreciation remains same irrespective of the no. of work shifts.

For other assets, if the asset is used for double shifts during any time of the year then the depreciation shall be increased by 50% for that period. Similarly if asset is used for triple shifts then depreciation shall be increased by 100% for that period.

A common approach to tax depreciation implies a common approach to dependency of the tax treatment on accounting.

Purpose of Selecting the Topic under Study

From the above discussion we have come across variation in the use of depreciation methods and mandatory application of method as per IRS of countries.

Choice of depreciation method has not only impact on taxation but also impacts the overall efficiency and profitability of the firm.

Income Tax rules in India allow only one method of depreciation i.e. WDV, where as the Companies Act allow two methods WDV and SLM.

The tax benefits availed on the depreciation, adds to the profit of the organization.

Whenever any CA thinks about charging depreciation, tax implications are of utmost importance. The synchronization of use of depreciation method by two important regulating authorizes may boost the performance of the industry.

In light of the above, the researcher has proposed following topic for study.

"Restriction on use of Depreciation method in Income Tax Act as compared to Companies Act and its effects in the industry"

Objectives of the Study:

To understand the effect of different depreciation methods on the tax calculations.

Even though the Indian income Tax Act has specified only one method of depreciation to be used by the companies/entity, the Company Act 1956 has been flexible to use two types of depreciation methods for companies under ROC. Similarly the other non registered business like proprietary, partnerships etc can use other methods.

In the context, the researcher felt the need to understand the effects of different depreciation methods on the Tax calculations.

To know the perceptions of Chartered Accountants (CA) and persons from Finance Department about the methods of depreciation charged.

The chartered accountants play an important role in the monitoring of financial status of the business specially the companies for which they work. The persons from Finance department and Chartered Accountants have been applying the depreciation methods for long as per the company rules and Income tax act. With implementation of IFRS being seen in near future, it is important to know their perceptions also about different methods of depreciation being charged.

To understand the effect of relaxation in the Change of method of depreciation by Income Tax Act.

If the Income tax department allows the use of other methods like Companies act, what will be the effects of these on the profitability of companies and also on the operations?

Will the synchronization of IT act and Companies Act regarding depreciation improve the efficiency of operations in the industry?

Period of Study:

The period of study is considered from 2001 to 2012.

Collection of Data and use of the methodology:

The researcher collected the data from the primary sources. The Chartered accountants, working as practitioners and Finance executives in different organizations are the participants included in the study thru questionnaire or Personal interviews.

Sampling Method: A simple random sampling methods were used.

Survey thru questionnaire: A detailed close ended questionnaire was prepared and sent to 150 Chartered accountants working in different sectors and companies out of which 115 have responded.

Utility of the Study

The study will help the number of beneficiaries in the process, mainly because the study has brought out the useful information about the non synchronization of use of depreciation methods by two important regulation authorities Income Tax Act and Companies Act.

The Utility of study will pervade as under.

It is useful to financial executives of the industry.

It may be useful for government while deciding on the IFRS implementation plan.

The study will also provide help to the IT department while deciding about the depreciation and its effect on tax procedures.

Questionnaire:

- Following questions were prepared for the present paper study.
- Which method of depreciation is used in by the professionals?
- What is the reason of using the existing method?
- Given the choice will you be willing to change the method?
- What is the reason for willingness to change the method?
- What will be the effect of using other method on Tax liability
- What will be effects of using other method on share holder' profit/growth?

Data analysis and Hypothesis testing:

Following two hypotheses are designed for the study.

Hypothesis 1 = "Willingness to change the method of depreciation is independent of the employment status of the chartered accountants."

Hypothesis 2 = "The Chartered accountants' perspective on the effects of using the different depreciation methods on tax liabilities are independent of type of companies."

The Researcher has used simple statistical techniques for the purpose of the said study by applying the Chi square test, degree of Freedom.

Willingness to Change the Method of depreciation: Perspective of CAs

Question: Given the choice will you be willing to change the method?

The hypothesis is tested to know the willingness to use different methods based on the data tabulated and the application of Chi Square method.

Hypothesis 1 = "Willingness to change the method of depreciation is independent of the employment status of the chartered accountants."

Table 1: Employments Type-Wise Classification - under Choice of use of Depreciation Method

Employment Type-Wise Classification				
Sl No.	Method Used	Self Employee	Private Employee	Total
1	SLM	18	17	35
2	WDV	46	26	72
3	Units of Production	1	1	2
4	SYD	0	0	0
5	DDB	2	4	6
	Total	67	48	115

Chi-sq. =3.199, DF=4 (Source: Survey)

Analysis and Result: At 4 degree of freedom, the calculated value of chi square i.e. $\mathbf{X^2}$ = 3.199 and the Table value at 5 % probability is 9.49. As the table value Tc > calculated Chi sq. X^2; therefore the difference is not significant. Hence the null hypothesis is accepted.

Probable Effects on Tax Liability by Using Other Depreciation Methods

Question: What will be the effect of using other method on Tax liability?

The Table below shows the number of Respondents on the probable effect on Tax liability on change of depreciation method. The hypothesis is framed and tested as below.

Hypothesis 2 = "The Chartered accountants' perspective on the effects of using the different depreciation methods on tax liabilities are independent of type of companies."

Table 2 showing effects of using the different depreciation methods on tax liabilities

Company Type -Wise Classification							
Sl. No	Effects on Tax Liability : Company wise respondents	Proprietary	Cooperative	SME	Medium Scale	Large Scale	Total
1	Increase in Tax Liability	15	0	21	5	2	43
2	No Effect on Tax Liability	23	1	14	9	3	50
3	Decrease in Tax Liability	3	2	11	4	2	22
	Total	41	3	46	18	7	115

Chi-sq. =13.609, DF=8 (Source: Survey)

Analysis and Result: At 8 degree of freedom, the calculated value of chi square i.e. $\mathbf{X^2}$ = 13.609 and the Table value at 5 % probability is 15.507. As the table value Tc > calculated Chi sq. X^2; therefore the difference is not significant. Hence the null hypothesis is accepted.

The Chartered accountants' perspective on the effects of using the different depreciation methods on tax liabilities is independent of the type of companies.

Findings and Conclusions:

From the survey it is observed that in more than 93 % companies the WDV method is being used as being mandatory for Income Tax calculations. Even though the companies Act permits the use of other method i.e. Straight Line method also, the companies do not want to increase their work and their balance sheets are also prepared with the WDV method only.

The prominent other reasons for use of depreciation methods as per the opinion of CAs is by CAs is that the WDV method is useful to claim more depreciation.

The duplication work restricts the CAS to continue with the same method of depreciation as per Income tax though Companies Act allows the other method.

CAs has mixed opinion about the effect of other methods on P& L and shareholders' profit.

CAs agree that the fair value is better concept as explained in new IAS 16 but they also feel that it will create complexity by considering fair value /market value for revaluation and NBV is being continued.

It is revealed that different methods must be allowed by Income Tax Act for better growth of business and economy as the same method may not be applicable to all types of business entity as the nature of business differs.

The application of proper depreciation methods will help to improve the financial transparency and to project the correct scenario of financial standings of the organization.

The restrictions on use of Depreciation methods limit the horizon of the functioning of the companies and business.

The effect of change of depreciation method on tax liability is wide open. 43 % CAs believe that the change of method will have no effect on the tax liability. 37% CAs are of the opinion that the change of method will cause normal increase in the tax liability.

The use of different methods affects the tax liability of the companies on year to year basis. Better planning of tax liability is possible with the use of appropriate method suitable to the type of business, type of products and type of assets of the company.

Suggestions and Recommendations for Future:

The absence of synchronization between the Companies Act and IT Act on the methodology for depreciation reduces the horizon of the companies on application of method. There has to be proper synchronized system/paper on this so that the companies get choice to use the better method and duplication of work can be avoided for companies to make their P&L statement.

The study revealed the need to apply the depreciation method as per the products of the companies, type of assets, the type of business etc. It is therefore deemed necessary to modify Income Tax rules and allow the category-wise use of depreciation methods.

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