

# AccountAble™

Depreciation and Its Accounting - 2

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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<sup>1</sup>. However, according to ICAI, the entry should be for a nominal value<sup>2</sup> only.

On the other hand, the American view<sup>3</sup> is that such assets should be recorded at a fair value<sup>4</sup>.

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-



<sup>1</sup> 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

<sup>2</sup> For example, Rupee one.

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

<sup>4</sup> Prevailing at the time of donation



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 particularly 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 19<sup>th</sup> 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<sup>8</sup>. 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 assesses. 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.

<sup>8</sup> 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         |
| <b>Total</b> | <b>16,010</b> | <b>Total</b>          | <b>16,010</b> |

The Balance Sheet will appear as below:

| Liabilities  | Rs.    | Assets    | Rs.   |
|--------------|--------|-----------|-------|
| General Fund | 15,000 | Furniture | 9,090 |

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

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