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Impact of Depreciation and Taxation Policy on the Profitability of Public Sector Enterprises

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Abstract

The depreciation policy of the business is evidenced by the rate at which depreciation is charged off each year. It must be remembered that depreciation is a cost of doing business which must, alongwith other expenses, be considered in determining net profits. A concern which is liberal in the amount charged off each year is said to have a conservative depreciation policy. In considering a depreciation policy a concern which is on the alert to repair and renew of its assets and thereby reduces the amount necessary to charge to depreciation each year. Before Independence, the main function of taxation was considered to be to raise an amount of revenue large enough to enable the Government to discharge its basic functions, and enough attention was not paid to the welfare responsibility and role of a welfare state. In 1956, the state was pledged to move in the direction of a socialistic society. Hence it was realised that the taxation policy and proposals should be so framed as to realise the goal of socialist economy. In this research paper researcher studied the impact of depreciation along with all aspect of providing depreciation in public sector enterprise including methods of depreciations and also the effects of depreciation under changes of price level and its practicability in India. Taxation is also a very important factor for computing profit of public sector enterprises so researcher studied direct and indirect taxation policies of Government of India.

Keywords: *Depreciation, Price level change, Taxation, Tax holidays.*

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1. INTRODUCTION

The whole theory of depreciation, therefore, implies that the capital sunk by any concern in the acquisition of its fixed assets must be preserved intact and that the loss in value arising from the use of such assets should be made good from revenue each year by distributing such charge fairly over their working life and not left over until the last moment when assets have ceased to be useful. Depreciation is loss of value in tangible assets arising from physical, functional and incidental causes. It includes also the loss in value of intangible assets that are affected by time limitation or abandonment. The term depreciation applies to assets which are limited in respect to time, such as patents, copyrights, trademarks, leases and so on. ***Deterioration*** is used to designate a loss in quality. This loss arises through wear and tear in the normal use of the asset, or it may be due to decay through the action of nature. ***Depletion*** arises in connection with assets which can not be replaced, or the duration of which can not be lengthened by repairs and renewals, and thus is a loss in quality. These assets are some-time referred to as wasting assets, oil wells and mines are subject to depletion, building and machinery depreciates. ***Obsolescence*** is the decline in value owing to technological improvements. Deterioration and obsolescence may both occur without any use of the asset.

Henceforth, depreciation will be used in the broader sense, that is, inclusive of depletion, deterioration and obsolescence.

2. OBJECTIVE

Objectives of this paper are as follows:

- To understand the various methods of charging depreciation in present scenario,
- To identity needs and methods of Charging Depreciation under changing price level,
- Taxation Policy in India, understanding the meaning of Set off and carry forward of losses.

3. METHODOLOGY

The present paper is based on secondary data. For collecting secondary data various books related to depreciation and taxation policies, research paper, news paper, magazines are consulted along with the internet.

4. DEPRECIATION VIS-A-VIS APPRECIATION

Appreciation is the opposite of depreciation. It is the increase in the value of an asset. Some companies have contended at times that since the appreciation in the value of their properties more than offsets the depreciation there was no net depreciation and, thus, no charge for depreciation against profits was made. Depreciation is not only a decline in the value of an asset due to wear and tear and other causes, but it is also a cost of doing business. Even though, appreciation in assets may take place, depreciation should be charged, if only, for the sake of the recognition of cost. Where there is marked appreciation in the value of an asset, it may established on the books of the company by a debit to the asset and a credit to unrealised surplus. However, this policy should be used only in exceptional cases.

5. VARIOUS METHODS OF CHARGING DEPRECIATION IN PRACTICE

There are several methods of charging depreciation. Some are more accurate than others. All, however, involve at least three factors:

1. Original Cost of the Asset.
2. Scrap or residual value
3. The estimated life of the Asset

Some methods involve a fourth consideration, namely, interest rate.

The following are the main methods of depreciation:

5.1 Straight Line Method: This is the simplest and commonly used method. By this arrangement the annual depreciation charge is equal to original cost of the asset minus the scrap value, the resultant net figure being divided by the estimated life in years.

5.2 Composite Life Method: In this method, the depreciation rate, instead of being applied to individual assets, is applied to all the assets. When the average rate is obtained it can be applied to all assets in one total charge.

5.3 Working Hour Method: In the straight line method the depreciation charge is based on time alone. In the working hour method, the basis is the number of hours that the asset is actually in use.

5.4 Unit Production Method: This method differs from the working hour method. In this method, first of all the cost of assets is divided by total units in life and then it is multiplied by units produced in a year.

5.5 Diminishing Value Method: This method is based upon the assumption that an asset depreciates more or less evenly percentage wise from the preceding period's value. In this scheme the book value of the asset would never reach zero, but it would in time reach the scrap or residual value.

5.6 Sum of Years' Digits Method: This is another method of depreciation where the amount of depreciation goes on decreasing in the coming years.

5.7 Compound Interest Method: The chief consideration involved in compound interest method is that the amounts set aside in depreciation fund are expected to earn interest like any other 'funds'. There interest accruals should reduce the amounts of the depreciation charges. In compound interest method, sinking fund method and annuity method are included.

5.8 Revaluation Method: At the close of each period an estimate is made of the value of the asset and the difference between the total original cost and present revaluation value is charged to depreciation.

6. DEPRECIATION UNDER CHANGING PRICE LEVEL

The existing technique of showing assets on historical cost method and charging depreciation on the basis of this cost is based on the principle that the fixed assets will be used for a long time. But it does not exhibit the real state of affairs of a company as rupee profits rise in a period of inflation and the fixed assets continue to be shown on historical cost basis and the depreciation is charged on that cost. Thus, the profits are over-stated to the extent of the rising price level creating secret reserves. Efforts should, therefore, be made to explore possibilities of improving financial reporting in times of rapidly changing prices.

The alternative methods of valuing fixed assets and providing depreciation under changing price level may be, the following:

1. Historical cost adjusted for changes in specific index number.
2. Historical cost adjusted for changes in general index number and

3. Replacement cost.

Under historical cost method, the fixed assets continue to be shown at the cost of their acquisition minus depreciation from year to year, irrespective of the change in the purchasing power of the rupee which is constantly falling in a period of rising prices.

6.1 Historical Cost Adjusted for Changes in Specific Index Number: By Specific Index Number, we mean that the index number of the cost of the asset, assuming the year of purchase as the base. In case the same is not available for the particular brand and type of Asset, Index Number of the group to which this asset belongs may form the basis for adjustment. Under this method the value of the asset shall be adjusted on the basis of the index-number of the asset at the beginning of the year and provision for depreciation shall be made at the fixed rate on the adjusted value.

6.2 Historical Cost Adjusted for Changes in General Index Number: Index Number of prices of representative goods and services which indicates the change in general price level are known as General Index Numbers. Under this method, the historical cost of the plant will be adjusted according to the Index Number at the beginning of year and provision for depreciation shall be made at the fixed rate per cent the adjusted value. The first thing that emerges from a study of the aforesaid alternative bases of valuing fixed assets and providing depreciation is that the liability for taxation is the highest in the existing historical cost method. Thus, in any case the historical cost method deserves rejection as under this method more taxes are paid, less depreciation fund accumulates, and last but not the least, the wage-earners get an opportunity to claim higher wages on the basis of fallacious profits at the cost of inadequate provision for depreciation. Not only this, the share-holders are also likely to be paid excessive dividends, may be even out of capital thereby leading to erosion of capital. The next problem is whether specific index number should form the basis of adjusting the historical cost. Usually the specific index number is more advantageous both in respect of tax liability and depreciation fund. But the position would be reversed if the rise in the general index number is greater than that in the specific index number. Thus, no one method is likely to give a lasting advantage over the other. There are, however, some practical difficulties in adopting the index number method. Firstly, the element of comparability will be destroyed as different enterprises may follow different methods of adjusting the historical cost (specific or general Index number method) based upon index numbers prepared by different units. The non-comparability of the financial statements will not only create confusion in the minds of the prospective investors but will also render difficulty for the economic analyst to derive any correct conclusion for the nation as a whole. Secondly, adjustment method may hold good to some extent in a period of rising prices but if a decline sets in, the depreciation fund will be even less than the actual cost. Thirdly, even if it is assumed that the trend of rising prices continues, the depreciation fund would not be sufficient to replace the asset at the end of its life.

6.3 Replacement Cost: The replacement cost means the market price at which the asset can be replaced. Under this method it is assumed that there will be continuous replacement of the depreciated asset value and the provision for depreciation is to be so adjusted each year that it makes available sufficient depreciation fund to replace the depreciated asset value at the

end of each year. The replacement cost method seems to be most equitable, besides creating sufficient fund to replace the plant and maintaining the capital intact in the form of purchasing power, it also gives the due share to the exchequer, the Shareholders and the wage earners, and thus the fear of dividends bring paid out of capital exchequer taking away more than its due share and the wage earners claiming for higher wages will also be eliminated. It may be argued that old plant is generally not replaced by a similar plant in an era of technological developments. Thus, the available fund will fall short of the replacement cost. Again, this method is opposed on the ground of complexity in its preparations as well as its difficulty in understanding by the general investors. Lastly, it may be alleged that it would be difficult to get every year the standard market price of the particular plant for replacement, as the design and pattern of plants are undergoing frequent changes these days. As such, they may favour the continuance of the historical cost method. The non-availability of the market price of a plant regularly throughout its life has little weight. But as in the early life of a plant its market price would be easily available (the change in design and pattern, being expected after a few years, the problem would arise only after some years when an improved type of plant would be introduced in the market and the manufacture of the old one is discontinued. In such a case the specific index number may form the basis of determining the market price. This replacement cost method of valuing fixed assets and providing depreciation seems to be the most equitable. It would be a good compromise if besides publishing the financial statements based on replacement cost method, supplementary reports according to historical cost method are also attached for the convenience of the general public.

7. ITS PRACTICABILITY IN INDIA

In case of India, the practices of other countries cannot be blindly accepted for application. In India, we do not have comparable index numbers for the period since 1939. Another problem that arises in this connection in the effect form which price level adjustment will be given effect to. Logically, a firm's accounts should be adjusted for the whole period to its life. In the case of older firms, it becomes a typical problem. The Institute of Chartered Accountants of India should consider the matter and attempt to suggest the method which will be followed by all the businesses while preparing the financial statements. Once the Institute formulates the plan for price level adjustments, all the practising Chartered Accounts will be guided by these and a greater uniformity will be brought about in the preparation of financial statements. So far as the question of preparing primary and final accounts exclusively in current values is concerned, it will be possible only when the Income Tax Act is amended in respect of the grant of depreciation allowance, and the Companies Act should also be amended to achieve uniformity in presentation. However, acting on the advice of the Institute of Chartered Accountants of India, The Govt. may amend these Acts to make presentation and audit of supplementary accounts compulsory. Such provisions in the Act, needless to say, will be specified in detail and leave no scope for manipulations.

8. TAXATION POLICY

Direct taxation may be classified into two categories, Income Tax and Other Taxes.

8.1 Income Tax

Income Tax is charged on the total income of the previous year of a corporation at the flat rate prescribed by the Finance Act for the particular assessment year. During the First Five Year plan period and the first year of the Second Five Year plan, the rate of Income Tax for Corporations was maintained at 25%. In 1957-58, the rate was increased to 30%, because the existing resources of revenue could not keep pace with the desired revenue required for the planned development of the country. In the last year of the Second Five Year plan period, the rate of Income Tax was reduced from 30% to 20%. Actually, this was not a relief of taxes because in the name of simplification of corporate taxation, the Govt. abolished the system of 'Grossing up of the dividend, the net effect of which was that the shareholders were required to pay tax on dividends declared in addition to the tax paid by the corporations on their profits.

The Finance Act, 1985 provides, the maximum rate of 50% in case of a domestic company in which the public are substantially interested and 60% in the case of a domestic company in which the public are not substantially interested. In the case of a company other than a domestic company, the maximum rate is 65%. Present rate of income tax on companies is 30%.

Surcharge on Income Tax: The object of imposing surcharge was to bring in more revenues to meet the increasing expenditure and to prevent inflationary pressure. The Govt. levied surcharge of Income Tax in The Finance Act, 1985-86. Thus, the amount of income tax computed in accordance with the preceding provisions of this Finance Act shall be increased by a surcharge calculated at the rate of 10% of such income tax.

Upto the Finance Act, 1964 Companies also paid super tax where it was called corporation tax. The Finance Act, 1965 merged the corporation tax with Income Tax and now the companies are liable to pay only Income Tax on their incomes at rates prescribed by the Finance Act.

8.2 Other Taxes

Corporations pay income tax on their revenues at the prescribed rates, but this alone does not indicate the total incidence of taxation on their incomes, as from time to time they have been asked to pay other taxes also like, Wealth Tax, Gift Tax etc.

Before 1951, The Govt. of India imposed Excess profit Tax on the excess profits earned to use in conditions w.e.f. 1st Sept., 1939. The tax was imposed on excess profits earned over standard profits of the base year at the rate of 50%. As the tax was a war measure, it was abolished w.e.f. 1st April, 1946.

After the abolition of E.P.T. Business Profits Tax was imposed from 1st April, 1946. The Corporations were liable to pay this tax on their business profits and it would not exceed 6 percent of capital or rupees one lakh whichever was greater. This tax was also abolished from 1st April, 1950.

8.2.1 After 1951

From 1st April, 1951 to 31st March, 1963, The Companies were required to pay only Income Tax and Super Tax and there was no other direct tax on their incomes. It was only with effect from 1st April, 1963, that a new tax was imposed on their super profits.

The tax on super profits of companies was imposed by the Super Profits Tax Act, 1963. This tax was abolished after a year of its adoption.

8.2.2 Incentives for Capital Maintenance - Depreciation Allowances

The Indian Income Tax Act provides liberal depreciation allowances to maintain the capital intact. The allowances are liberal in the sense that the normal depreciation is allowed for normal use of the asset, extra shift allowance is allowed for multiple shift working, initial depreciation is allowed at the rate of 40% of the cost of buildings erected for residence or welfare of the low paid staff and in the case of transfer of asset the capital loss is allowed as terminal depreciation.

If the profit of a business in any year is not sufficient to absorb the depreciation allowances, the unabsorbed balance can be carried forward to subsequent years and set off against profits of the business in any later year or years, provided there is no change in the ownership of the business. Thus, an assessee can get back 100% capital invested in buildings, furniture, plant and machinery used for the business or profession.

8.2.3 Set Off and Carry-Forward of Losses

The losses suffered in a year can be set off against any other income of the same year. If the business and capital losses could not be wholly set off on account of insufficiency of profits, the balance of the amount not so set off can be carried forward to be set off in the next eight years regarding business loss and short-term capital loss and in next four years in case of long-term capital losses.

9. GRANT OF CAPITAL EXPENDITURE

Capital expenditure on Scientific Research or research of a Medical nature which has a special relation to the welfare of workers employed in the business is deductible at the rate of 20% in each of the five consecutive accounting years. Similar treatment is accorded to capital expenditure incurred for promoting family planning amongst the employees.

Thus, the grant of capital expenditure helps in maintaining the capital intact. In tenth uses the industrialists to promote family planning amongst their employees, to use the latest patents and to set up scientific laboratories for improving the quality of goods.

10. DEVELOPMENT REBATE

A special deduction by way of development rebate was allowed at a specified percentage on the cost of a new ship or a new plant and machinery owned by the assessee and used wholly for the purpose of business. Development rebate has been discontinued after 31st May, 1974. However, unabsorbed development rebate would be carried-forward for a period not exceeding eight assessment years.

11. TAX HOLIDAY

An important tax incentive to encourage establishment of new industries is the tax holiday for the first five years after commencement of manufacture. The profits are exempted from tax upto a limit of 6 per cent of the capital employed in the undertaking. The impact of the incentive varies with the Capital structure and profitability of the undertaking as the exemption is granted on the basis of capital employed. A company may not be able to utilized fully this incentive because of the absence of sufficient operating profits against which the tax holiday is to be utilised. New undertakings have a considerable gestation period and often show little or no profits in the initial years. In the first few years, infact the depreciation allowances and the investment allowance are

large enough to offset tax purposes. The result in many cases is that there are either no taxable profits or only a small amount is left for the concession of a tax holiday. In order to make it more effective the tax holiday benefit may be applicable from the time a surplus is available after providing depreciation and investment allowances.

Before 1965, it was compulsory to deduct the depreciation and development rebate before claiming the advantage of tax holiday. In a case Supreme Court held that an assessee can postpone the claim for depreciation allowance. By so postponing the claim for depreciation allowances for the period of tax holiday and also not lose the claim for depreciation, which will in any case be allowed in subsequent years. In the case of a company assessee profits and gains derived from an industrial undertaking which beings to manufacture or produce articles or operate its cold storage plant after 31st March, 1976 or from a ship which is first brought in two use after that date or from the business of a hotel which starts functioning after that rate deduction at the rate of 7½% will be allowable in place of 6 per cent. The benefit of deduction is allowed for a period of first five assessment years. Where the industrial undertaking etc. are run by a cooperative society, the deduction is allowed for a period of seven assessment years.

12. CONCLUSION

The conclusion is that all assets which are more or less constantly in use, naturally diminish in value by reason of wear and tear. As the wasting of an asset contributes to the expense and in order to arrive at the profits of an undertaking, it is imperative that the question of depreciation should be considered, as no true profit can be ascertained until all losses or expenses incurred for the purpose of earning an income are charged against such income. Another reason, why depreciation should be brought into account is that unless the shrinkage in the value of the assets, due from any cause, is provided for, the value of assets will be overstated in the Balance Sheet. High rate of taxation has adversely influenced the growth of corporations. The tax policy of the Government seems to be one of trial and errors; taxes on dividends distribution and issue of bonus shares were levied and later withdrawn when they failed in their purpose. The super profits tax had to be replaced by sur-tax in the following year.

Although tax incentives have been given, the conditions attached to them are generally difficult of fulfilment and the advantages are not as widespread as they could otherwise be. Thus, we conclude that the taxation policy of the Government should not only maximise the flow of funds to the exchequer but also promote the generation of funds for further investment, create employment, boost production and earnings and in turn reap larger revenues for the Government to defray the increasing current expenditure on social welfare.

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