

Charging of Pro Rata Depreciation

The following is the opinion given by the Expert Advisory Committee of the ICAI in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') is a fully owned Government of Madhya Pradesh (GoMP) company and was incorporated in May, 2002 after unbundling of erstwhile State Electricity Board (SEB). However, the commercial operations commenced from 1st June, 2005 pursuant to GoMP Notification No. 226 dated 31st May, 2005.
2. The company is engaged in the business of electricity distribution in the area of Indore and Ujjain Commissionaire of State of Madhya Pradesh and is governed by the provisions of the Electricity Act, 2003. The company is responsible for all activities associated with distribution of power within its territory, including management of assets, operation and maintenance of network and supply, technical and financial planning, business development and management of human resources, legal and regulatory affairs, etc.
3. The querist has stated that as per the accounting policy of the company, depreciation on addition/retirement of fixed assets is provided on 'pro rata basis' from beginning of quarter in which the asset was put to use.
4. However, while conducting audit of annual accounts of the company for financial year (F.Y.) 2014-15, the government auditor (C&AG auditor) has following observation in this regard:

"Depreciation and amortisation expenses

This is overstated by ₹2.96 crore due to adoption of depreciation method for addition to fixed assets during the year on quarterly basis in deviation to AS 6. As per the accounting policy of the company, depreciation on addition to fixed assets is provided on pro rata basis. However, in deviation to its own accounting policy, the company while calculating the depreciation on addition to fixed assets, worked out on quarterly basis, i.e., from the beginning of the quarter in which the asset was put to use, irrespective of the date on which the asset was actually put to use. Thus, the company in deviation to Accounting Standard (AS) 6 'Depreciation Accounting' and also its own accounting policy worked out the depreciation on addition to fixed

assets on quarterly basis instead of pro rata basis. This has resulted in overstatement of Depreciation & Amortisation Expenses and understatement of fixed asset by ₹2.96 crore. Consequently, loss for the year is overstated by similar amount."

5. In response to above, the company has submitted the following reply:

"CAG audit observed that the company while calculating the depreciation on addition to fixed assets, worked out on quarterly basis, i.e., from the beginning of the quarter in which the asset was put to use, irrespective of the date on which the asset was actually put to use. Thus, the company is in deviation of Accounting Standard (AS) 6, 'Depreciation Accounting'.

In this regard, it is stated that depreciation is to be charged on pro rata basis, however, the meaning of pro rata basis is not defined. Hence, kind attention is invited on 'Guidance Note on Accounting for Depreciation in Companies' which provides the following accounting treatment in case of pro rata depreciation:

"24. Note no. 4 in Schedule XIV to the Companies Act, 1956, prescribes that "where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed". The Committee is of the view that a company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging *pro rata* depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved."

It is clearly mentioned above that the company may calculate pro rata depreciation on 15 days basis, or monthly basis or quarterly basis.

Accordingly, based on the principle of materiality, the company has grouped the addition of assets on quarterly basis for depreciation on assets."

6. The C&AG auditor was also requested to consider the directions given in Madhya Pradesh Electricity Regulatory Commission (MPERC) (Terms and Conditions For Determination of Tariff For Supply and Wheeling of Electricity And Methods and Principles For Fixation of Charges) Regulations, 2009 {G - 35 of 2009}. The relevant extracts of the same are reproduced as under:

“30 Depreciation

30(1)(g) Depreciation shall be chargeable from the first Year of commercial operation. In case of commercial operation of the asset for part of the Year, depreciation shall be charged on *pro rata* basis”.

7. Further, an earlier opinion of the Expert Advisory Committee of ICAI on related subject matter was also submitted to C&AG auditors, in which the Committee is of the view that a company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved. However, it was not considered by C&AG auditors.

B. Query

8. In light of the above facts, the querist has requested the Expert Advisory Committee to provide the opinion that whether the treatment given by the company of charging depreciation for addition and disposal of fixed assets during the year pro rata on quarterly basis is correct or not.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to appropriateness of the method of charging the depreciation for addition and disposal of fixed assets during the year pro-rata on quarterly basis. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, determination of the rates of depreciation, etc. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of various legal enactments such as, MPERC Regulations, Electricity Act, 2003, etc. Further, as a reference has been made to AS 6, the Committee has not examined the requirements of Accounting

Standards revised vide MCA Notification dated March 30, 2016 and Indian Accounting Standards (Ind ASs).

10. At the outset, the Committee notes that the company is charging depreciation from the beginning of the quarter in which the asset was put to use whereas as per the requirements of the Schedule II to the Companies Act, 2013, depreciation should be charged from the date when the asset is available for use by the company rather than from the date when the asset is put to use. However, the Committee notes that MPERC Regulations require depreciation on assets to be charged from the first year of commercial operation and Part B of Schedule II to the Companies Act, 2013 also states that “the useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of this Schedule”. Therefore, since whether requirements of MPERC Regulations would be covered under Part B of Schedule II or not, would involve interpretation of MPERC Regulations and since the same is also not the issue raised in the extant case, the Committee has not examined the issue as to whether in the extant case, the company should charge depreciation from the date the asset is put to use/commercial operation or the date when it is available for use by the company. Further, since the company is not differentiating between these two dates, it is presumed from the Facts of the Case that these dates are same in the extant case and accordingly, the Committee has restricted itself to the issue raised of charging the pro rata depreciation on quarterly basis.
11. The Committee further notes that the company is charging depreciation from the beginning of the quarter in which the asset was put to use irrespective of the date on which the asset was actually put to use. In this regard, the Committee notes the requirements of Note 2 of Schedule II of the Companies Act, 2013 which states as follows:
- “Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up

to the date on which such asset has been sold, discarded, demolished or destroyed.”

From the above, the Committee notes that Schedule II requires calculation of depreciation on pro rata basis for any additions/disposals of assets made during the year. The Committee notes that the manner of providing pro rata depreciation has been explained in paragraph 59 of the Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013¹ which states as follows:

“Pro-rata Depreciation

59. Note no. 2 in Schedule II prescribes that “where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed.” The company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved.”

From the above, the Committee notes that the Guidance Note allows grouping of assets acquired or disposed of on quarterly basis for providing pro rata depreciation subject to the considerations of materiality of the amounts involved. The Committee is of the view that ideally, as a matter of principle, depreciation should be calculated from the date the asset is available for use (i.e., on daily basis). However, as a matter of administrative convenience, the Guidance Note allows grouping of assets acquired or disposed of on a 15 days/monthly/quarterly basis and calculation of depreciation on such assets accordingly unless the amounts involved are material. In other words, the intention behind such grouping is that to the extent possible, the depreciation so calculated should not be materially different from the actual depreciation, computed from the date the asset is available for use. As far as materiality is concerned, it is a matter of judgement and needs to be considered in the specific facts and circumstances of the company.

Accordingly, the Committee is of the view that in the extant case, the company may continue to charge pro rata depreciation on additions and disposal of assets on quarterly basis provided the amounts involved are not material. However, if the amounts involved for specific assets are material, the company should consider grouping of additions and disposals of such assets on some more suitable basis, for example, on monthly or 15 days period basis, etc.

D. Opinion

12. On the basis of above, the Committee is of the opinion that the company may continue to charge pro rata depreciation on additions and disposal of assets on quarterly basis provided the amounts involved are not material. However, if the amounts involved for specific assets are material, the company should consider grouping of additions and disposals of such assets on some more suitable basis, for example, on monthly or 15 days period basis, etc., as discussed in paragraph 11 above.

1.	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2.	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on May 4, 2017. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3.	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty five volumes. A CD of Compendium of Opinions containing thirty five volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4.	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5.	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in .

¹ The said Guidance Note was issued in the year 2016, whereas the query relates to the financial year 2014-15. However, since in the extant case, the requirements of Companies Act, 2013 are applicable, in the context of which this Guidance Note has been issued, the same has been referred to. Further, since the erstwhile Guidance Note on Accounting for Depreciation in Companies (which was in force during the financial year 2014-15) was in context of Schedule XIV to the Companies Act, 1956 and contained same requirements in respect of pro-rata depreciation, the same has not been referred to.