



Depreciation Accounting

With specific reference to the
Companies Act 2013

Key issues on Depreciation in Companies Act 2013

Our discussion will generally center around the following topic:

- Understanding the differences in the Acts of 1956 and 2013.
- Useful life
- Componentization
- Initial transition to Companies Act 2013 (restricted to Accounting for Fixed assets and depreciation).
- Other concepts.

The legal foundations:

- Companies Act 2013
 - **Sec 2(57)** reserves created out of write-back of depreciation not to be part of net worth.
 - **Sec 123(1)(a)** dividend not to be paid out of profits without providing for depreciation – both current year or for earlier year.
 - **Sec 123(2)** Depreciation to be charged as per Schedule II
 - **Sec 198(4)(k)** Depreciation to be deducted before arriving at profit.
 - **Schedule II**
- Ministry of Corporate affairs notification **GSR 237(E) dated 31-3-14**
- Ministry of Corporate affairs notification **GSR 627(E) dated 29-8-14**
- **AS 10** Accounting for Fixed Assets
- **AS 26** Accounting for intangible assets

First look at the key changes in the Act regarding depreciation accounting.

Companies Act 2013

- Schedule II to the 2013 Act
- Useful life of the assets given
- '*depreciable amount*': cost less residual value
- '*residual value*' ordinarily should not be > 5% of original cost of the asset
- For companies which are required to comply with AS should disclose a justification if useful lives used $\neq$ prescribed (technical advice necessary)
- Component accounting

Companies Act 1956

- Schedule XIV of the 1956 Act
- Specified rates of depreciation given.
- Depreciable amount not defined.
- No such value restriction
- No such requirement
- No such requirement

Useful Life of Fixed Assets



Useful life

Useful life may be considered as a period over which:

- ✓ an asset is available for use; or
- ✓ as the number of production or similar units expected to be obtained from the asset by the entity; or
- ✓ specified time after which the assets are planned to be disposed off; or
- ✓ after consumption of a specified proportion of the future economic benefits embodied in the asset.

The useful life of the asset may therefore be shorter than its economic life.

Assessing Useful life

- Useful life of fixed assets is given in part C of Schedule II of the Companies Act 2013.
- The companies may adopt a useful life or residual value different from that mentioned above, however the same should be disclosed and justified with technical advice. (**GSR 627E dt 29-8-14**)
- Useful life as mentioned in the Act is for the whole asset and useful life of components will have to be assessed separately.

Mandatory in respect of FY commencing
on or after April 1 2015

Componentisation



Old habits die hard.

Conventionally (and also as per AS 10) the idea was that if there are any major repairs and improvements to an asset that would significantly increase the benefits to be derived from that asset beyond that for which it was originally estimated, the cost would be capitalised. For instance, if the plant capable of producing 10,000 units could now produce say 11,000 units i.e. increased capacity.

Let us take an example:

Under the 1956 Act, if an aircraft with life of 10 years needs to change its engine after 5 years then the cost of the new engine is not capitalised but charged to profit and loss because even with the new engine the aircraft's usual life (and therefore productivity) remains 10 years.

Thus, the entire cost of the aircraft is depreciated over the period of 10 years and the 5th/6th year sees a sudden jump in repair costs in the P/L Account. This distorts the performance picture for that year.

The Messiah arrives:

What does the Companies Act 2013 says about componentisation:

Useful life specified in Part C (*part of schedule II where useful life of assets are mentioned*) **of the Schedule** (*i.e. schedule II*) **is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.**

Taking our cue: IFRS

The concept of componentisation can be found in IAS 16 Property, Plants and Equipment. Because Corporate Financial Reporting is transitioning to IFRS based standards, it was reasonable to expect these provisions in Companies Act 2013.

In the next slide we will see how componentisation will accounting and since this is a new phenomenon, we shall be drawing inspiration from IFRS experience.

Few facts:

First thing, please note that as per schedule II of the Companies Act 2013, depreciation includes amortisation.

While significant component costs of parts having separate useful life from the total asset is to be depreciated separately, what constitutes '**significant**' is not defined. It may be argued, component costs are significant if the resultant depreciation based on its separate useful life is '**material item**' non-disclosure of which will result in the reader of the financial statement drawing conclusion based on that financial statement, different from which he might have concluded if the component cost was disclosed and depreciated separately.

Department's rules regarding materiality may be applied

What kind of items may be componentised

IFRS gives us some idea in its paragraph 13 and 14:

1. Firstly some items of fixed assets may require replacement at regular intervals. For instance, furnace may require relining after specified number of hours of use (whether by statute or otherwise) these would constitute separate component.
2. Aircrafts may need to replace some parts like seats and galleys.
3. A condition of continuing to operate a fixed asset (eg aircraft, power plant- recall mandated residual life study) may be performing regular major inspections for faults regardless of whether parts of items are replaced.

Accounting for component cost.

1. Component costs are recognised albeit separately if they fit the definition of fixed assets. **Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services** (AS 10) over more than one year (IAS 16/ IndAS 16).
2. AS 10 (paragraph 8.3) recommends that components with separate useful life can be accounted separately. **(earlier permitted as per AS, now required as per Act)**
3. These component assets are to be depreciated separately at rates commensurate with its useful life.
4. If these components have residual value when they are replaced, the residual value is to be charged off to P/L Account as period costs.

Do all assets in the assets register need to be componentized?

Not all assets of an enterprise need to be componentized.

Enterprises typically have a large number of assets accounted for as fixed assets, but in terms of cost, a large percentage of those assets may constitute an insignificant proportion of total value.

Such assets are not required to be componentized. Therefore, most asset componentization efforts will be focused on a small number of assets that are significant in cost and have separable major components.

Typical approach to componentization



Technical
Analysis.

Identification of
Assets to be
componentised.

Identification of
Component
and their costs.

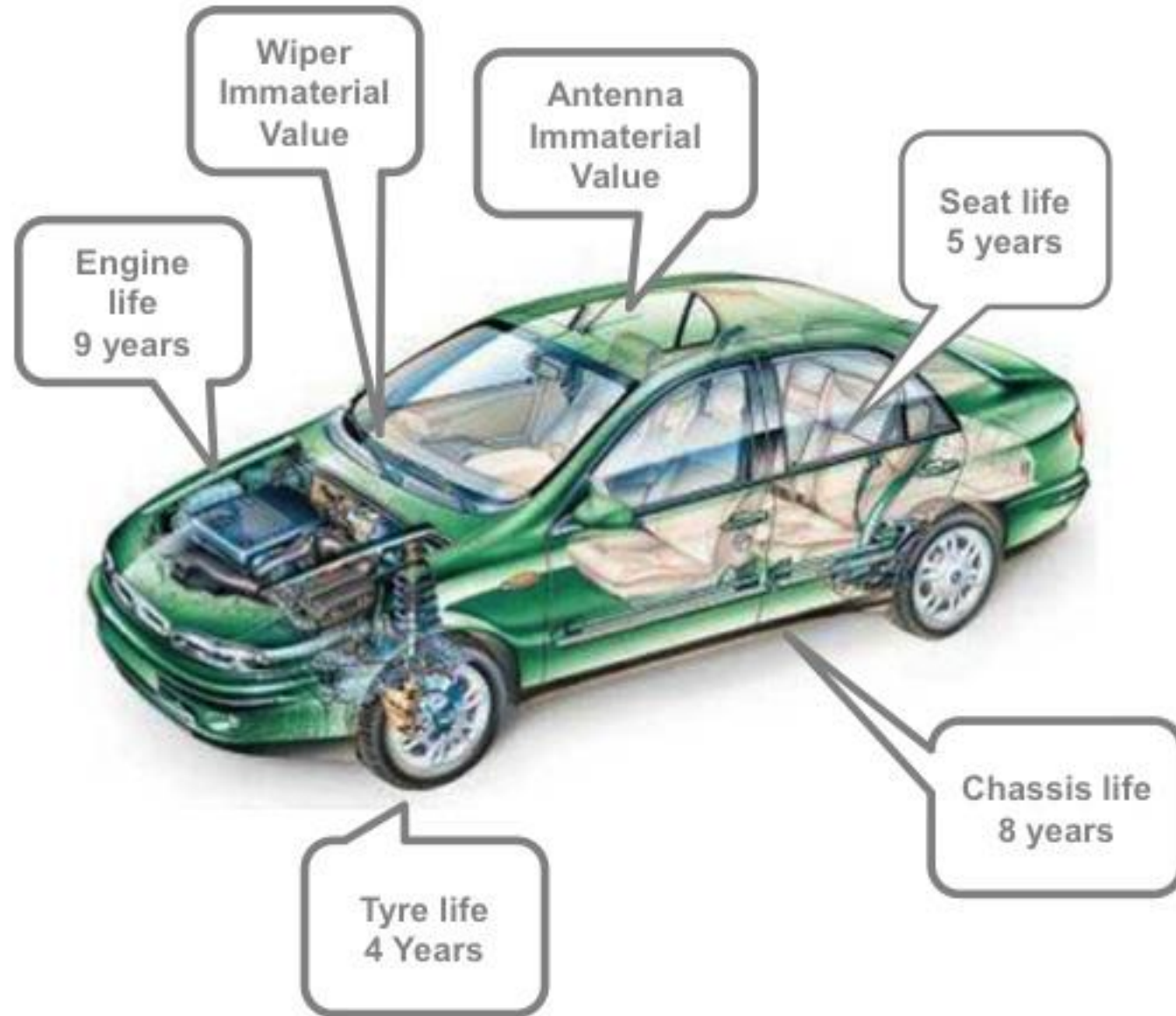
Step 1: Technical analysis: Understand the production process and how the assets are utilized through a detailed review of flow diagrams, equipment layout plans and other technical information with assistance of plant technical team.



Step 2: Identify assets to be componentized: Evaluate fixed assets to identify significant principal assets with major and separable components. Evaluate materiality by estimating the impact on profit/loss of not applying component accounting to less costly items of fixed assets.



Step 3: Identify the components and their costs: For assets where component accounting is deemed appropriate, the concepts of materiality, component separability, and useful life are used as a guide for the level of componentization to be carried out. Based on the concept of “price break-down” or the “component built-up pricing” model, the gross book value and net book value of the identified components are established.



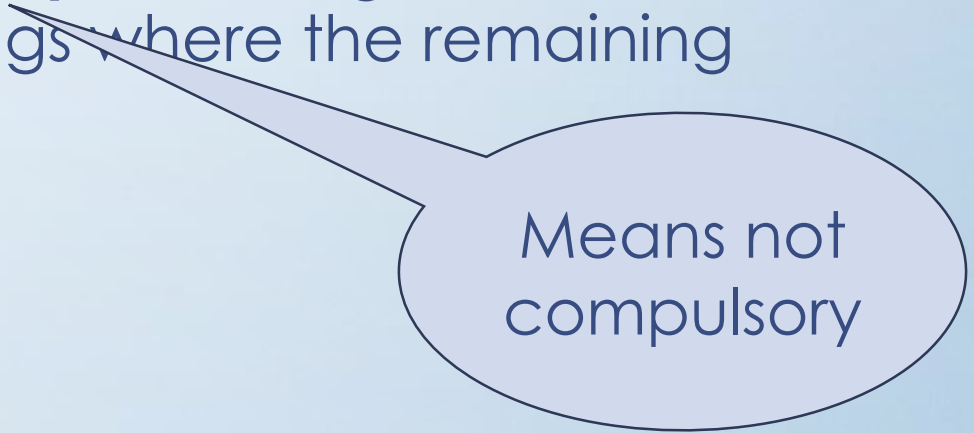
Initial Transition



As of 1 April 2014

From the date s Schedule II comes into effect, the carrying amount of the asset as on that date –

- (a) shall be depreciated over the remaining useful life of the asset as per this Schedule;
- (b) after retaining the residual value, **may** be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil.



Means not compulsory

Other Issues



Other Issues

Part A of Schedule II of the Companies Act 2013 defines:

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.

The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

Depreciation includes **Amortisation**.

Methods of Depreciation

The Act does not define how depreciable value could be allocated in each year of the useful life of the Asset. It could be by:

- ✓ Straight line method
- ✓ Written-down Value method
- ✓ Unit production method (schedule II hints at this)
- ✓ Or any other justifiable method.

Amortisation

- ❖ For intangible assets, the provisions of the accounting standards applicable for the time being in force shall apply, except in case of intangible assets (Toll Roads) created under 'Build, Operate and Transfer', 'Build, Own, Operate and Transfer' **GSR 237(E) dated 31-3-14**
- ❖ **Accounting Standard (AS) 26** deals with Intangible assets. As per paragraph 63, the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

For BOT/BOOT

Mode of Amortisation:

$$\text{Amortisation rate} = \frac{\text{Amortisation amount}}{\text{Cost of amortisation}} \times 100$$

Amortisation Amount:

$$\text{Cost of intangible assets} \times \frac{\text{Actual Revenue for the year}}{\text{Projected revenue from intangible assets (till the end of the concession period)}}$$

Meaning of particulars are as follows:

Cost of Intangible Assets	Actual Revenue for the year	Projected Revenue from Intangible Asset
Cost incurred by the company in accordance with the accounting standards	Actual revenue (Toll Charges) received during the accounting year	Total projected revenue from the Intangible Assets as provided to the project lender at the time of financial closure / agreement.

BOT/BOOT contd...

- The amortisation amount or rate should ensure that the whole of the cost of the intangible asset is amortised over the concession period.
- Revenue shall be reviewed at the end of each financial year and projected revenue shall be adjusted to reflect such changes, if any, in the estimates as will lead to the actual collection at the end of the concession period.

Misc.

Entities that are subject to regulatory authorities control regarding chargeable depreciation, shall calculate depreciation as allowed by such regulatory authority. Eg power companies.

Pro-rata depreciation for assets available for part of the year.

Disclosure of useful life, depreciation method must.

The useful lives of assets working on shift basis have been specified in the Schedule II based on their single shift working. Except for assets in respect of which no extra shift depreciation is permitted (indicated by **NESD** in Part C), if an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period.

Misc.

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Misc.

- ✓ "Factory buildings" does not include offices, godowns, staff quarters
- ✓ “Continuous process plant” means a plant which is required and designed to operate for twenty-four hours a day.

Should the reader have any additional questions, please refer them to the email address given at the end of the slides. Please give details of the fact.

Q&A



Q1

Schedule XIV to the 1956 Act provided for depreciation on both straight line method (SLM) and Written Down Value Method (WDV). Are both these methods of deprecation available even under Schedule II when only useful life has been prescribed and not the rates of depreciation?

Paragraph 1 of Part A to Schedule II, inter alia, states “Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.”

The key phrases used in the above referred paragraph are 'systematic allocation', 'period over which an asset is expected to be available for use', 'number of production or other similar units expected to be obtained'.

Accordingly, a company when adopting the useful life of assets specified in Schedule II may use rates derived based on WDV or SLM or units of production method for depreciating the assets.

For example, General Plant and Machinery having a useful life of 15 years, having a residual value of 5% and working single shift may be depreciated

- @ 6.33% p.a. over 15 years on SLM basis such that 95% of the cost of the asset is depreciated over the useful life of 15 years.
- @ 18% p.a. over 15 years on WDV basis such that 95% of the cost of the asset is depreciated over the useful life of 15 years.
- Based on the actual units produced as a proportion of the total number of units estimated to be produced, subject to revising the estimate of production periodically such that 95% of the cost of the asset is depreciated.

Q2

When a company opts to move to Schedule II useful lives and residual values, can they simultaneously also change the method of depreciation and still avail benefits of transition provisions?

While transitioning to the useful lives and residual value as per Schedule II, a company may decide to change the method of depreciation (SLM, WDV, etc). Since the company is transitioning to Schedule II, it may be able to avail benefits of transition provisions even if it changed the method of depreciation.

However, this would need to be done on a two stage basis:

- In the first stage, consequent to the change in the method of depreciation, as on the date of transition to Schedule II, the carrying value of the assets should be recalculated based on the equivalent rates considering the erstwhile useful lives and the deficiency or surplus arising from the retrospective computation of depreciation in accordance with the changed method, should be charged or credited to the Statement of Profit and Loss for that year, as per the provisions of para 15 of AS 6. Such a change in method would be treated as a change in accounting policy and its effect should be quantified and disclosed in the financial statements.
- In the second stage, the revised useful life should be considered for depreciating the aforesaid recalculated carrying values and such recalculated carrying values should be considered for applying the transition provisions of Schedule II.

Q3

Can a company adopt for some class of assets Schedule II useful lives and residual values and for some other class of assets a different useful life and residual value?

A company would have to determine category wise useful life and residual value considering the usage of the assets and / or their location.

Hence, it is permissible for companies to consider useful life and residual value per Schedule II for some categories of assets and different life / residual value for the other categories of assets.

However, the rationale is to be technically evaluated and disclosed in the financial statements where useful life as per Schedule II is not being applied.

When a company adopts Schedule II for depreciation subsequent to the first quarter in the year of transition, is it required to restate prior quarter results?

Adoption of Schedule II would result in a change in accounting estimate and the manner of providing depreciation. Para 23 of AS 5 provides the following:

‘The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

- (a) the period of the change, if the change affects the period only; or
- (b) the period of the change and future periods, if the change affects both.’

Para 27 of AS 5 states, 'The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.'

Hence, if the company were to adopt Schedule II in the second quarter of the year of adoption (say September 2014),

- the cumulative impact would be recognised in the current quarter (i.e. September 2014) and
- the impact for the preceding quarter (i.e., June 2014 in this example) included in the current quarter (i.e. September 2014) should be disclosed separately as a Note to the financial results along with the cumulative impact.

Thus in this example, both in the "Quarter ended September 30, 2014" and "Six months ended September 30, 2014" columns, the full effect of the change from 1 April, 2014 would be indicated and the effect on the previous quarter as well as the cumulative effect would be given by way of a Note.

Is componentisation to be done retrospectively or prospectively?

Schedule II does not exempt componentisation of existing assets. Hence, in whichever year a company adopts componentisation, all assets would have to be componentised retrospectively but with respect to only those assets that have a carrying value greater than the residual value as on the transition date.

Further, such requirement is voluntary in respect of financial year commencing on or after 1 April, 2014 and mandatory for financial statements in respect of financial years commencing on or after 1 April, 2015.

Accordingly, the transition provision under Note 7 of Schedule II will be available to a company on 1 April, 2015 with respect to componentisation, if they opt for componentisation with effect from that date, though it adopted the other provisions (useful life) of Schedule II as on 1 April, 2014.

What are the broad considerations that a company must have when they componentise their assets?

Normally, only when the useful lives are significantly different from each other, a componentisation exercise should be embarked upon. Also, whether componentisation is required to present a fair measurement of the depreciation expense and the carrying value of the asset must be considered.

- Information technology (IT) personnel may be involved in the exercise as IT systems would need to be configured appropriately.
- Threshold value of asset beyond which they will be subject to componentisation.
- Threshold value or percentage of cost of the component vis-à-vis the total cost of the asset.
- Threshold proportion of the useful life of that part vis-à-vis the useful life of the remaining asset.

Based on the revised useful lives as per Schedule II, should the carrying value as of 31st March 2014, also be adjusted to reflect the change in such useful lives?

For e.g. the useful life of a Continuous Process Plant (CPP) is 25 years whilst the derived useful life under Schedule XIV to the Companies Act, 1956 was 18 years. Under this circumstance can a company write back the excess depreciation charged on such CPP in earlier years until March 31, 2014 consequent to the adoption of useful life of such asset as per Schedule II?

The carrying value as of March 31, 2014 should not be reworked as per Schedule II under any circumstance.

The transition provision provided in clause (a) of Note 7 to Schedule II states that the carrying value as on the date the Schedule comes into effect should be depreciated over the remaining useful life as per the Schedule.

What treatment should be given for assets costing less than Rs. 5,000/-, given that no specific guidance has been provided for the same in Schedule II?

Schedule II does not specifically deal with assets costing less than Rs. 5,000/-.

As per AS 1 - Disclosure of Accounting Policies, a company has to give due consideration to the concept of materiality when framing its accounting policies and preparation of financial statements.

Considering the above, a company would be free to determine a policy for depreciating assets costing less than Rs. 5,000/- prospectively. The policy adopted for depreciating such low value assets, where applicable, would have to be disclosed in the financial statements.

Such assets depreciated previously under the earlier policy should not be reinstated.

With respect to amortisation of intangible assets, since Schedule II covers only road projects, what is the manner of amortising other intangibles assets which were covered under the erstwhile Schedule XIV?

Also, should a recalculation from day one be done or should amortisation of the WDV be over the remaining life?

It appears that only intangibles in case of road projects can continue with the revenue model for amortization specified in Schedule II.

Intangible assets that arise out of other BOOT projects such as port projects, railways, etc. may have to be amortised as per AS 26. Amortisation based on revenue model may no longer be available for such assets.

Hence, a change from the revenue model to amortisation as per AS 26 in such cases would be a change in the method of depreciation and, accordingly, treated as a change in accounting policy as per AS 6, requiring a retrospective application.

It may be noted that such intangible assets would have been amortised over the same period (based on useful life) under AS 26 and under the erstwhile Schedule XIV to the 1956 Act, albeit under different methods.

However, since this change in amortisation model is triggered by statute, keeping in mind that Schedule II contains transition provisions for amortising the carrying amounts on the date of transition over the balance life of the asset, it would be appropriate to apply the change prospectively i.e. the carrying value of the intangible assets as at April 1, 2014 (date of transition to Schedule II) will be amortised over the balance useful life of the asset on a systematic basis. This transition may need to be applied even in the interim periods from the date Schedule II becomes effective to the company.

The transitional provisions of AS 26 may not apply since there may not be a change in the total useful life of the asset.

Is useful life of special plant and machinery determined based on nature of the asset or its usage?

Schedule II specifies the useful life of special plant and machinery based on usage and not on the nature of the asset.

For example, an Earth-moving Equipment used in an entity that is engaged in open cast mining has been specified a useful life of 8 years (without extra shift depreciation), whereas similar Earth-moving Equipment used in the construction industry has been specified a single shift useful life of 9 years.

Whether an existing asset as at 31 March 2014 which was not identified and considered as continuous process plant (CPP) under Schedule XIV of the 1956 Act in the financial statements can be retagged/ redetermined as CPP under Schedule II of the 2013 Act?

No. The definition of CPP has not changed under the 2013 Act as compared to the 1956 Act.

Further, Note 7 of Part C to Schedule II, which specifies the transition provision on the date when the Schedule comes into effect, states the manner of dealing with (only) the carrying value of the assets as on the date of transition. It does not provide for reversing or recalculating depreciation charged in periods prior to the effective date of the Schedule.

When a company adopts Schedule II for depreciation, is it required to restate prior year financial statements based on revised useful life as per Schedule II, in case of an initial public offer of securities?

Adoption of Schedule II is not a change in accounting policy but is a change in accounting estimate and the manner of providing depreciation.

Note 7 to Part C of Schedule II provides for applying the useful life prospectively, such that:

- a) the carrying amount of assets on the date of transition into Schedule II are depreciated over the remaining useful life of the asset; and
- b) after retaining the residual value, recognised (optional) in the opening balance of retained earnings where the remaining useful of an asset as on that date is nil.

SEBI requires restatement of prior year financial statements included in the Offer Document arising from:

- i. Incorrect accounting policies, failures to make provisions or other adjustments leading to auditor qualifications
- ii. Change in accounting policy
- iii. Material amounts relating to adjustments for previous years shall be identified and adjusted in arriving at the profits of the years to which they relate irrespective of the year in which the event triggering the profit or loss occurred.

This should be more in the nature of Prior Period Items - Errors Or Omissions.

As per the ICAI GN on Reports in Company Prospectuses (Revised) - Para 2.2(b) - "..... In other words, where there are material facts which would have been taken into consideration while preparing the accounts for the respective years, had those facts been known at that time, the same should be considered in the year to which it relates.

The auditor should, therefore, review the relevant information in respect of earlier years, such as, settlement of significant items already reported as prior period adjustments, extraordinary items identified and adjusted in the respective years, etc."

Considering the above,

- a) If the transition provision (a) above is applicable, there may be no need for restating the prior year financial statements for the effect on depreciation for the change in the useful life.
- b) If the transition provision (b) above is applicable, the amount recognised in the opening balance of retained earnings may be allocated / attributed to the respective prior year financial statements.

Disclaimer

This e-module is not an substitute for the original documents such as the Companies Act of 1956 and 2013, the accounting standards (AS) or the Indian Accounting standards(IndAS) and other such documents. The purpose of this e-module is to introduce the reader to the changing paradigm of accounting for fixed assets and in more specific that for depreciation.

The Companies Act 2013, is a forward looking law. It envisages that eventually IFRS based IndAS would be the sole GAAP. However, in the intermittent period old AS continue to be part of GAAP. This creates a dichotomy where underlying concepts could be explained only by reference to IFRS/IndAS. On occasion, AS is found to be significantly deficient (e.g.. In defining fixed assets, it does not mentions that the economic benefit should be derived across more than one year).

Readers are requested to always refer to the authoritative sources of the law/standard for their work. They are also requested to please keep themselves informed of any developments in the field of Company law and Corporate Reporting.

Thank you

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