Accounting of depreciation under the Companies Act, 2013

This article aims to

- Provide an overview of the requirements of the Companies Act, 2013 with respect to accounting of depreciation
- Highlight the related key guidance comprised in the guidance note and application guide issued by the Institute of Chartered Accountants of India (ICAI).

Introduction

Under the Companies Act, 2013 (2013 Act), depreciation accounting assumes a new order, from a regime of prescription based depreciation rates, the new law now provides only indicative rates and requires management to exercise judgement in arriving at rates for depreciation based on the expected usage pattern of assets.

Section 123 of the 2013 Act requires that a company declares or pays dividends out of the profits of the company for that year which is arrived at after providing for depreciation in accordance with Schedule II of the 2013 Act (Schedule II). Similarly, for payment of managerial remuneration to the Directors, net profits are to be computed after deducting the amount of depreciation calculated in accordance with Section 123 of the 2013 Act.

Therefore, Section 123 and Schedule II lay down the requirements for depreciation under the 2013 Act.

To help understand the requirements of the Schedule II, the Institute of Chartered of Accountants of India (ICAI) has issued an application guide (Application Guide on Provisions of Schedule II to the 2013 Act) and a guidance note (Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the 2013 Act) in the past. Additionally, the ICAI has recently issued an educational material on the Ind AS 16, *Property, Plant and Equipment* which provides the key requirements of the standard and the Frequently Asked Questions (FAQs) covering the issues which are expected to be encountered frequently while implementing the standard.

It is important to note that with the revised Accounting Standard (AS) 10, *Property, Plant and Equipment* and withdrawal of AS 6, *Depreciation Accounting,* the requirements of AS and Indian Accounting Standards (Ind AS) are largely similar now.

This article summarises the provisions governing depreciation under Schedule II and how they differ from the provisions of the erstwhile Schedule XIV. Additionally, it also highlights the related key guidance/ clarifications comprised in the application guide and guidance note issued by the ICAI.

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Key provisions of the Schedule II

Following is an overview of the key provisions for accounting of depreciation as provided under the Schedule II:

Useful life and residual value of assets

Schedule II defines depreciation as the systematic allocation of the depreciable amount of an asset over its useful life. The definition contains two significant terms – depreciable amount and useful life. These terms have been defined as follows:

a. *Depreciable amount* of an asset is the cost of an asset or other amounts substituted for cost, less its residual value.

b. 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.

Therefore, it means that the companies are required to depreciate assets over their useful life after considering the residual value.

Schedule XIV of the Companies Act, 1956 was prescriptive in nature as it specified the minimum rates of depreciation to be applied under Straight Line Method (SLM) or Written Down Value (WDV) method for different class of assets. Schedule II, on the other hand provides indicative useful lives for various tangible assets and states that the residual value of an asset should not be more than five per cent of the original cost of the asset.

The guidance note and the application guide clarified that the useful life and residual value of assets (contained in Schedule II) are indicative in nature. Therefore, companies may determine different useful life and residual value of the assets which could be higher or lower than those specified in the Schedule II. However, in case a company uses a different useful life (higher or lower than specified in Schedule II) or a residual value of more than five percent, the financial statements of the company should disclose such difference and provide justification duly supported by a technical advice.

Moreover, both AS 10 and Ind AS 16, *Property, Plant and Equipment* require that the residual value and the useful life of an asset should be reviewed at least at each financial year end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate. Additionally, the Ind AS Transition Facilitation Group (ITFG) in its Bulletin 11[1] also clarified that selection of the method of depreciation (e.g. SLM or WDV) is an accounting estimate, and not selection of an accounting policy.

Useful life or residual value governed by other regulatory authority

Part B of the Schedule II explicitly 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 should be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of the Schedule II.

Such a provision was not present in the Schedule XIV, except for the companies engaged in the generation/supply of electricity wherein it had been specifically clarified[2] that the depreciation charged under the Electricity Act, 2003 would prevail over the Schedule XIV for such companies.

Component accounting mandatory

Useful life prescribed under Schedule II is for whole of the asset. However, where cost of 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 significant part should be determined separately. Such an approach is known as 'component accounting' which is mandatory under the 2013 Act and requires companies to identify and depreciate significant components with different useful lives separately.

The application of component accounting could pose significant challenge for the companies in terms of identification of significant components of an asset and determining the cost of such components. The guidance note and the application guide provide detailed guidance in these areas.

Identification of significant components

Identification of significant components requires a careful assessment of facts and circumstances. Such an assessment would include at a minimum:

- Comparison of the cost allocated to the item to the total cost of the aggregated Property, Plant and Equipment (PPE) and
- Consideration of potential impact of componentisation on the depreciation expense.

As a company is required to identify only material/significant components separately for the purpose of charging depreciation, materiality is a matter of judgement that need to be decided on the facts of each case. The guidance note gives indicators to assess significant components:

- Determine the threshold value to determine which asset requires componentisation.
- Threshold value in percentage of cost of component to the total cost of the asset
- Proportion of useful life of that part as compared to the useful life of the asset
- Potential impact on the total depreciation expenditure.

1. ITFG Clarification Bulletin 11 dated 1 August 2017 issued by the ICAI.

2. General circular dated 31 May 2011 issued by the Ministry of Corporate Affairs (MCA).

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Companies also need to consider impact on retained earnings, current year profit or loss and future profit or loss (i.e. when the part would be replaced) in order to decide materiality. The application guide mentions that companies may consider 10 per cent of original cost of the asset as a threshold to determine whether a component is material/significant.

Determination of cost of significant components

With respect to determination of the cost of such parts, the application guide and the guidance note prescribe following criteria which can be used by the companies for determining the cost of such parts:

a. Break-up cost provided by the vendor
b. Cost break-up given by internal/ external technical expert
c. Fair values of various components or
d. Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset.

Depreciation of significant components

Every significant component which has a useful life different from the remaining asset should be depreciated separately. Therefore, two situations could arise and they are as follows:

- *Useful life of the component is lower than the useful life of the principal asset as per Schedule II:* Such lower life should be used for computing depreciation for the component.
- *Useful life of the component is higher than the useful life of the principal asset as per Schedule II:* Though a company has a choice of using either the higher or the lower useful life, use of higher life is permitted only when the management of the company intends to use the component even after the expiry of the useful life of the principal asset.

In practice, an issue may arise in case of companies that are depreciating their PPE based on prescribed regulatory rates. In such cases, whether such companies could identify components and depreciate them using a different rate remains as a moot point.

Amortisation of intangible assets

Depreciation also includes amortisation of intangibles as per Schedule II. Schedule II specifically mentions that intangible assets will be amortised as per Ind AS for companies following Ind AS road map.

Accordingly, Ind AS 38, *Intangible Assets* specifies that the accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is to be amortised, however, an intangible asset with an indefinite useful life is not amortised.

Amortisation for an intangible with finite useful life should begin when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Amortisation should cease at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations* and the date that the asset is derecognised.

Additionally, the amortisation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, then the straight-line method should be used.

On 31 March 2014[3], the Ministry of Corporate Affairs (MCA) amended the provisions relating to determination of useful lives of intangible assets prescribed in Schedule II. The amendment permitted companies to apply revenue-based amortisation, based on the proportion of actual revenue for the year as compared to the total projected revenue from the intangible asset during the concession period for 'toll road' intangible assets.

However, Ind AS 38, specifies that an amortisation method based on revenue generated by an activity that includes the use of an intangible asset is presumed to be inappropriate, except in very limited circumstances.

In order to transition to Ind AS, Ind AS 101, *First-time Adoption of Indian Accounting Standards* permits companies to apply a previously used amortisation method for such toll-road intangibles only to assets existing at the beginning of the first year of adoption of Ind AS.

This represented an inconsistency between the guidance in Schedule II and in Ind AS.

Accordingly, MCA recently amended[4] Schedule II replacing a part of the provision relating to intangible assets and provides the following:

- **Companies following Ind AS:** Companies following Ind AS would be unable to apply revenue-based amortisation method to toll road related intangible assets that are recognised after the beginning of the first year of adoption of Ind AS.

3. MCA notification no. G.S.R. 237(E) dated 31 March 2014.
4. MCA notification no. G.S.R 1075(E) dated 17 November 2016 and corrigendum dated 9 December 2016.

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- **Companies following AS:** Companies that continue to follow AS are permitted to continue applying the exception in Schedule II and use a revenue-based amortisation method for their toll road intangibles.

Continuous Process Plant (CPP)[5] and multiple shift depreciation

With useful life and component approach guidance, the provisions relating to CPP and multiple shift depreciation have been realigned accordingly.

CPP

CPP means a plant which is required and designed to operate for 24-hours a day. The guidance note specifically requires that the term used in the definition 'required and designed to operate for 24-hours a day' should be interpreted with reference to the inherent technical nature of the plant, i.e., the technical design of a CPP should be such that there is a requirement to run it continuously for 24-hours a day. Such a plant could be shut down for some time (for instance due to lack of demand, maintenance etc.), however such a shut down does not change the inherent technical nature of the plant. It would still be considered as a CPP and useful life as estimated would be applicable for providing depreciation.

Additionally, it is to be noted that a CPP is distinct from the repetitive process plant or assembly-line type plants. These plants are not CPP since such plants do not involve significant shut-down and/or start-up costs and are not technically required and designed to operate 24-hours a day, for example, an automobile manufacturing plant. Therefore, determination of whether a PPE is a CPP could be subjective and may require technical evaluation.

Schedule II indicates useful life, of CPP, for example, 25 years for 'CPP, other than those for which special rates' has been prescribed in the Schedule II and certain special rates for others.

The Guidance note and the application guide reiterates that the principle of estimation of useful life and concept of component accounting are also applicable to a CPP.

On the other hand, Schedule XIV, inter alia, specified the general rates of 15.28 per cent under WDV method and 5.33 per cent under the Straight Line Method (SLM) of depreciation for 'CPP, other than those for which special rates' had been prescribed.

It is important to note that what has been considered as CPP under the Schedule II is the same as it was under Schedule XIV i.e. a plant which was not a CPP under Schedule XIV could not be a CPP under Schedule II.

Multiple shift depreciation

The useful lives of assets specified under Schedule II are based on their single shift working. However, where a company estimated the useful life of an asset on a single shift basis at the beginning of the year but uses the asset on double or triple shift during the year, then the depreciation expense would increase by 50 or 100 per cent as the case may be for that period.

The guidance note requires that the company should determine whether the use of an asset for an extra shift was on sporadic basis in the past and would continue in future also. If the use is on a sporadic basis, then the depreciation expense for the double or triple shift should be increased by 50 per cent or 100 per cent as the case may be for the period of use.

However, if the company estimates that the use of the asset for extra shift would not be on a sporadic basis i.e. the extra shift working for the asset would be on regular or continuous basis, it should reassess its useful life considering its use on extra shift basis. Hence, the reassessed useful life should then be used for the purpose of charging depreciation expense.

Schedule XIV specified substantially different requirements of depreciation. It specified separate rates of depreciation for single, double and triple shift use of assets. Both under Schedule XIV and Schedule II, extra shift depreciation is applicable only for the actual number of days for which the asset has been operated on double/triple shift basis.

Further, it should be noted that in case the useful life has been estimated on double/triple shift basis at the beginning of the year, the concept of extra shift depreciation will not apply. In such an instance, the company will need to evaluate whether there is any change in the circumstances on which the useful life of asset was based or any new developments have taken place which may have impact on the estimated useful life of the asset. If there is any such indication, the company should reassess the remaining useful life of the assets on the basis of the changed circumstances/new developments. For instance, use of the asset on a single shift basis in future.

Depreciation on low value items

Schedule XIV included specific provision for depreciating assets at the rate of 100 per cent whose actual cost did not exceed INR5,000. This provision was based on the practices followed by the companies based on the materiality of the financial impact of such charge.

5. CPP means a plant which is required and designed to operate for 24-hours a day.

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However, since the life of an asset is a matter of estimation, therefore, Schedule II does not prescribe such a bright line. A company could have a policy to fully depreciate assets up to certain threshold limits considering materiality aspect in the year of acquisition. The materiality of such a charge should be considered with reference to the cost of the asset and the size of the company.

Similar issue has been considered and clarified in the educational material on Ind AS 16 and it states that determination of an individual item as insignificant and not considering the same as PPE is a matter of professional judgement which requires careful assessment of facts and circumstances including qualitative aspects. Accordingly, individual insignificant assets below a certain threshold determined by the management may not be recognised as PPE. These may be expensed if their cumulative aggregate cost for that category of asset is not material.

Disclosures

In case of deviation from the indicative useful life and/or residual value prescribed in Schedule II, companies are required to disclose useful life and/or residual value of assets adopted along with the fact that the adopted useful lives and residual values are duly supported by a technical advice.

Keeping in view the estimations and assumptions involved around determination of useful lives/residual value, disclosure requirements prescribed under Schedule II definitely aim to promote best practices and transparency.

Consider this

- Although the provisions of Schedule II offer flexibility to the companies i.e. it allows companies to follow different useful life/residual value, the management will have to technically evaluate and make use of judgement for determination of useful life and identification of significant parts.
- Accounting of depreciation has an impact on the distributable profits and calculation of managerial remuneration.
- Useful life, depreciation method and residual values of the PPE are considered as accounting estimates.

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