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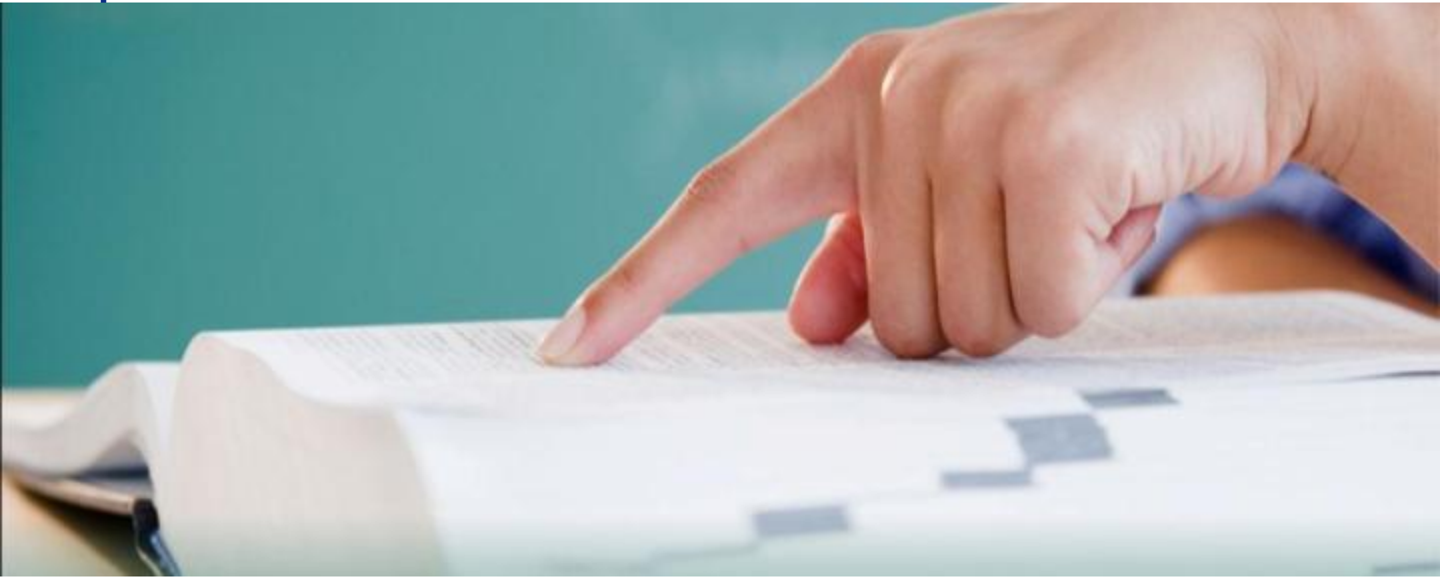
FIRST NOTES
KPMG in India

The MCA amends norms relating to useful life and residual value; clarifies certain aspects of capitalisation of costs

1 September 2014



First Notes on:

Financial Reporting

Corporate law updates

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Sector:

All

Banking and Insurance

Information, Communication, Entertainment

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Infrastructure and Government

Relevant to:

All

Audit committee

CFO

Others

Transition:

Immediately

Within the next 3 months

Post 3 months but within 6 months

Post 6 months

Recently, the Ministry of Corporate Affairs (MCA) has issued certain amendments and clarifications relating to the application of certain provisions of the Companies Act, 2013 (the Act) relating to computation of depreciation expenditure (useful lives and residual values[1]) and capitalisation of costs for power projects[2].

This issue of First Notes summarises the important aspects arising from amendments to schedule II of the Act, and the MCA clarification on capitalisation of costs by companies engaged in power projects.

Amendments to schedule II of the Act

Useful life prescribed in schedule II of the Act are indicative

At present schedule II requires the following:

- the useful life of an asset should not be longer than the useful life prescribed in Part C of schedule II, and
- the residual value of an asset should not be more than five per cent of its original cost

unless the company adopting a useful life or using a residual value different from the above limits, discloses the justification for the difference in the financial statements.

The amendments made by the MCA now prescribe the following:

- the useful life of an asset should not ordinarily be different from those prescribed in Part C of schedule II,
- if a company adopts a useful life different from those prescribed in Part C of schedule II or uses a residual value higher than five per cent of the original cost of the asset, the financial statements would need to disclose the fact and provide a justification for different useful life or residual value duly supported by technical advice.

1 Vide notification dated 29 August 2014
2 Vide general circular dated 27 August 2014

Component approach mandatory from 1 April 2015

Schedule II currently requires that companies should determine significant components of their assets and if useful life of such significant components is different from useful life of the asset then the useful life of that significant component would be determined separately (i.e. follow a component approach).

The MCA has amended the applicability date for following the component approach. As per the amendment, component approach would be voluntary in respect of the financial year commencing on or after 1 April 2014, and will be mandatory for the financial statements in respect of financial years commencing on or after 1 April 2015.

Adjustment to opening retained earnings not mandatory

Currently, schedule II prescribes specific transitional guidance to enable companies to comply with the provisions of the Act. The transition requires that on 1 April 2014 the carrying amount of the asset:

- would be depreciated over the remaining useful life of the asset as per the schedule II,
- after considering the residual value, would be adjusted against the opening balance of retained earnings where the remaining useful life of an asset is nil.

The MCA has amended the requirement for 'adjustment of the opening balance of the retained earnings' by making it optional for companies.

Capitalisation of costs by companies constructing power projects – the MCA clarification

After consulting the Accounting Standards Board of the Institute of Chartered Accountants of India, the MCA has provided following clarifications for companies involved in the construction of power projects:

- Under AS 10, *Accounting for Fixed Assets* and AS 16, *Borrowing Costs*, only costs that increase the worth of the assets are eligible for capitalisation.

  Based on this principle, the MCA has clarified that the costs incurred during any periods of extended delay in commencement of commercial production (for reasons beyond the control of the developer) after the power plant is ready for use does not increase the worth of fixed assets. Therefore, cost during such periods should not be capitalised as costs of the power project.

- AS 16 provides that when the construction of an asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to the completed part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

  Based on the above principle, the MCA has clarified that in case one of the units of a power project is ready for commercial production and is capable of being used, while the other units are still under construction, costs incurred upto the point the unit becomes ready for commercial production are eligible for capitalisation. Cost incurred after the unit is ready for use can not be capitalised even though other units are still under construction.

- The MCA has further clarified that principles of AS 10 and AS 16 is applicable to all power projects i.e. whether the power project is a 'cost plus project' or a 'competitive bid project'.

Our comments

- Schedule XIV of the Companies Act, 1956 prescribed minimum depreciation rates for assets. For a large number of assets, the schedule II prescribes useful lives that are significantly lower than those envisaged in schedule XIV to the Companies Act, 1956. The amendments to the schedule II issued by the MCA provide relief to the companies and provides them greater flexibility in determining useful lives if their estimates and experience suggests that they are different from those prescribed under schedule II.

- The MCA amendment does not explicitly require that technical advice to support the useful lives of assets has to be provided by an external specialist. While some companies may approach specialists to support their estimates; this is an area that could be challenging to implement if companies or auditors are unable (for lack of specific experience or skill) to arrive at or validate these estimates.

- The MCA amendment regarding schedule II does not provide any transitional guidance. If a company wishes to adopt the MCA amendment from adjustment to retained earnings to adjustment to the statement of profit and loss then a question arises as to whether listed companies would be able to reverse any adjustment to the retained earnings previously recorded in interim financial statements.

- Certain regulated entities such as banking companies that follow the Reserve Bank of India's regulations are not allowed by regulations to make any adjustment to retained earnings without prior regulatory approval e.g., they were not allowed to adjust the carrying amount of the assets that on transition had nil useful lives. The MCA amendment relating to transition to the Act now helps them to route the adjustments through the statement of profit and loss.

- Under AS 10, the component approach is recommendatory in nature. Deferring the applicability of the component approach will provide adequate time to companies in order to modify their financial reporting systems even if it compromises comparability in the short run.

- Adoption of the component approach will also bring companies a step closer towards international practices.

- The clarification issued by the MCA on AS 10 and AS 16 is a reiteration of the existing accounting principles. This is expected to bring in consistency in the application of these principles, and also align the practices with those followed internationally. As a prudent practice, the above MCA clarification could also be adopted by companies involved in the construction of assets with long construction period and which can be operatonalised in phases e.g. airports/dams/highway projects, etc.

The bottom line

- The amendments to schedule II are welcome and were awaited as there was inconsistency in the manner in which companies had applied these new depreciation requirements when reporting their first quarter results. We believe that these proposed amendments are a step in the right direction, although we continue to believe that the MCA should seek to undertake an extensive post-implementation review of the Act rather than drip feed amendments.

- Companies in the power sector following accounting practices contrary to the MCA clarification might get significantly impacted. It may be appropriate for such companies to align their accounting practices with retrospective effect and disclose the impact existing at the beginning of the year as a prior period item.

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Introducing Voices on Reporting

KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

On 24 July 2014, the International Accounting Standards Board (IASB) issued the completed version of IFRS 9, Financial Instruments (IFRS 9 (2014)), which substantially concluded the challenging project launched in 2008 to replace IAS 39, Financial Instruments: Recognition and Measurement. We provided an overview on IFRS 9 (2014) in the call.

Recently on 14 August 2014, the MCA has amended the Companies (Meetings of Board and its Powers) Rules, 2014 (Rules) by removing the paid- up share capital criterion and has revised transaction level thresholds.

We discussed the approval process for the related party transactions under the Companies Act, 2013 and the SEBI guidelines under Clause 40 of the Equity Listing Agreement and highlighted implementation challenges that corporate India is expected to face.

August 2014

July 2014

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