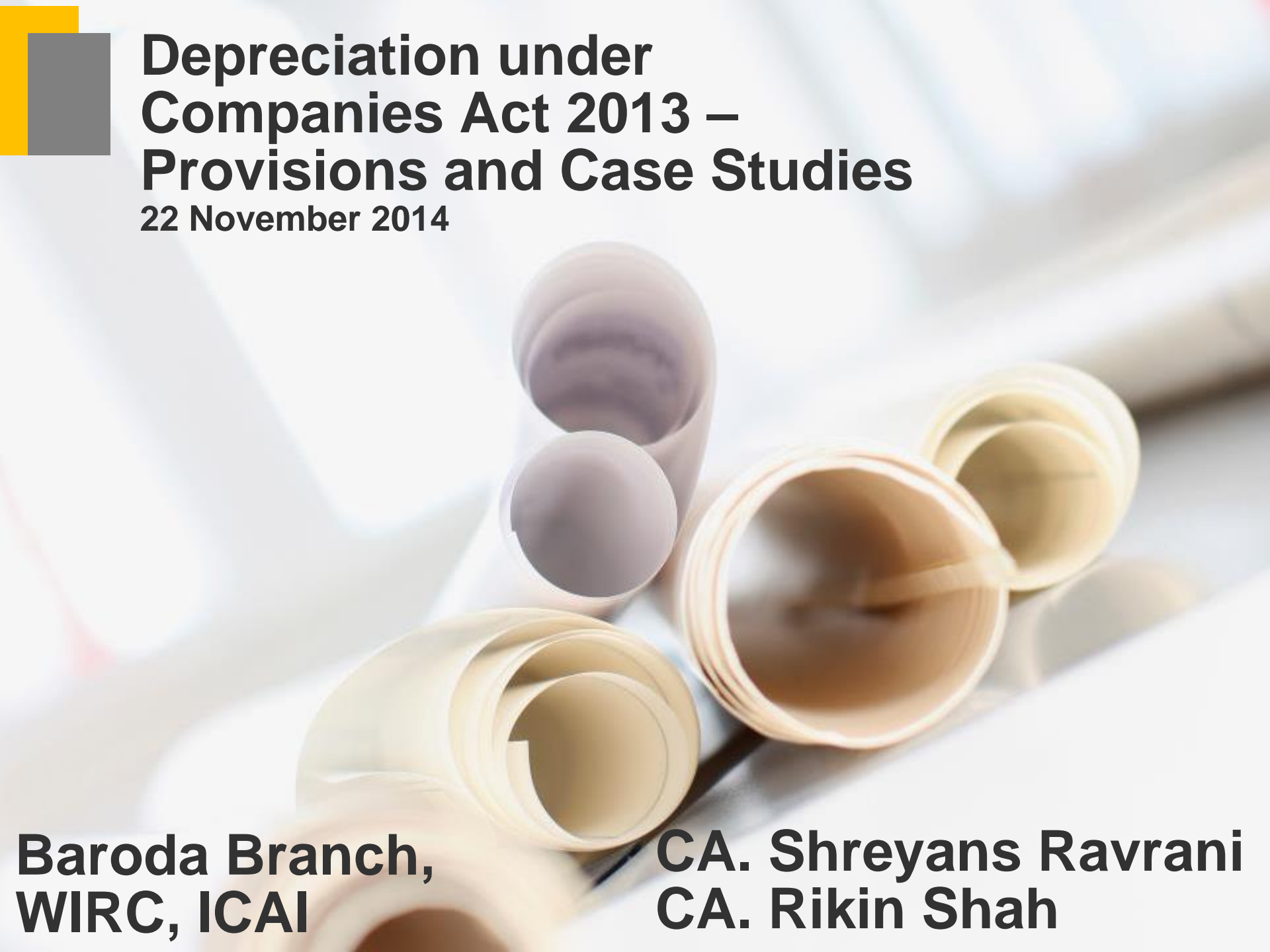




# **Depreciation under Companies Act 2013 – Provisions and Case Studies**

**22 November 2014**



**Baroda Branch,  
WIRC, ICAI**

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# Agenda

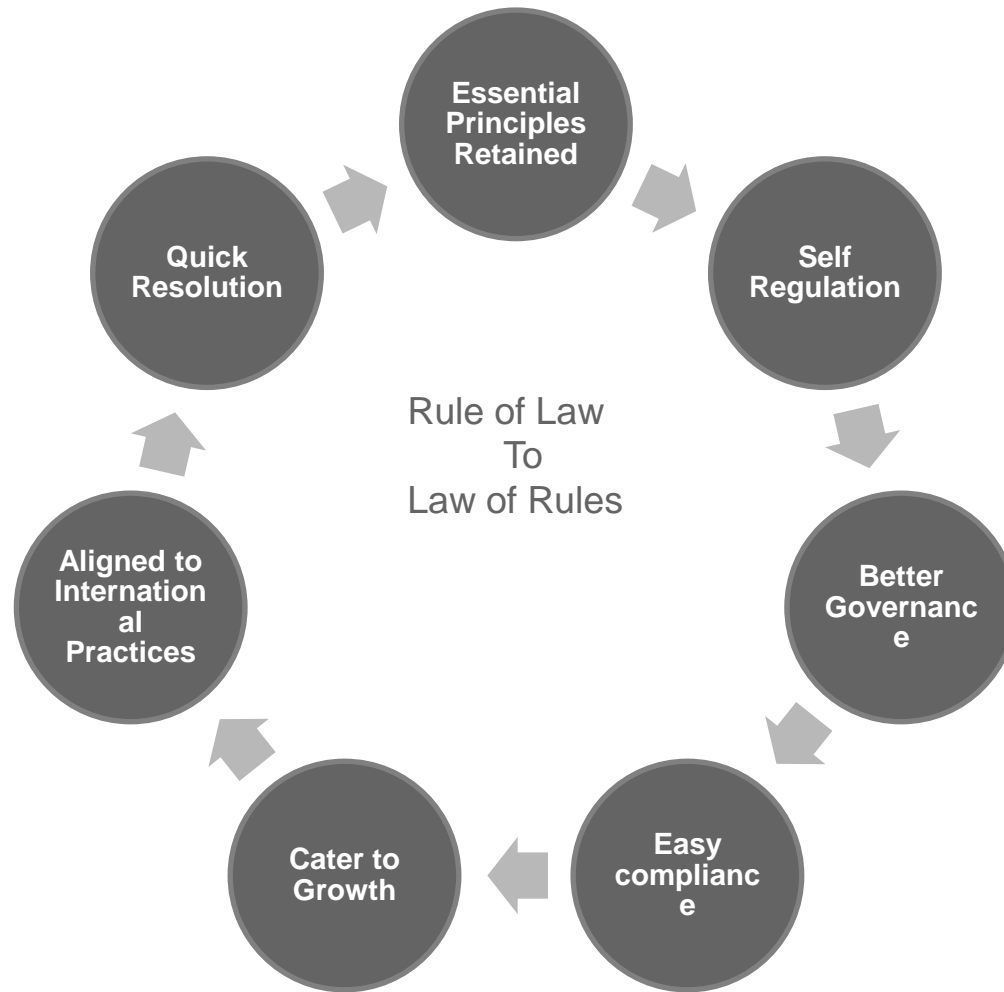
- ▶ Overview of key developments
- ▶ Depreciation:
  - ▶ Overview and key changes
  - ▶ Method of depreciation
  - ▶ Change in useful life & its implications
  - ▶ Impact on Dividend and Managerial Remuneration
- ▶ Component accounting
  - ▶ Identification of components
  - ▶ Accounting of replacement / repairing costs
  - ▶ Disclosures
- ▶ Key impact

# Overview of key developments

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- ▶ Passed by the Lok Sabha on 18 December 2012
- ▶ Passed by the Rajya Sabha on 8 August 2013
- ▶ Received the President assent on 29 August 2013 and notified on 30 August 2013
- ▶ MCA released draft Rules for comments in 6 Phases during September to November 2013. Comment period for last phase expired in December 2013
- ▶ MCA is implementing the 2013 Act in a phased manner
- ▶ Out of total 470 sections, 283 sections have been notified till 16 April 2014
- ▶ Final rules released for 19 Chapters - Covers most of the notified sections
- ▶ SEBI, vide Circular dated 17 April 2014, amended Clauses 35B and 49 of the Listing Agreement
  - ▶ RC49, among other matters, deals with aspects such as related party transactions, independent directors, Audit Committee and vigil mechanism
  - ▶ Purpose is to align with the 2013 Act - there are significant differences between the two
  - ▶ RC49 applicable from 1 October 2014

# Approach of new company Law



# Depreciation



# Depreciation Overview

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- ▶ Depreciation is systematic allocation of the depreciable amount of an asset over its **useful life**.
- ▶ Depreciable assets are assets which
  - ▶ are expected to be used during **more than one accounting period**; and
  - ▶ have a **limited useful life**; and
  - ▶ are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and **not for the purpose of sale** in the ordinary course of business.
- ▶ Assets valuing less than a specified amount say, Rs 1 lacs always charged to statement of profit & loss – Is this treatment correct
- ▶ EAC opinion by ICAI – On ground of materiality, assets valuing less than specified amount can be charged to profit & loss. Such charge doesn't amount of non-compliance of AS 6 or AS 10
- ▶ Depreciation on assets held for sale – They are valued at lower of carrying amount and net realisable value, hence, depreciation is not applicable

# Depreciation

## Comparison of Schedule II and Schedule XIV

- ▶ Indicative useful life prescribed
- ▶ No reference to method
- ▶ Unit of production method allowed
- ▶ Guidance for useful life on Intangible assets
- ▶ Component accounting covered and mandatory
- ▶ Extra Shift depreciation simplified
- ▶ No reference to depreciation on low value items
- ▶ Transition provisions
- ▶ Rate of depreciation prescribed
- ▶ SLM / WDV Method
- ▶ UOP was not allowed
- ▶ No guidance for useful life on intangible assets except IA under BOT model
- ▶ No reference to component accounting
- ▶ Extra shift depreciation was based on number of days
- ▶ Items less than Rs 5,000 to be charged off

# Depreciation

## Schedule II - Overview and key changes

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- ▶ Provisions relating to depreciation contained in schedule II of the Companies Act, 2013 which was earlier under schedule XIV of the Companies Act 1956
- ▶ Schedule II is divided into three parts:
  - ▶ Part A – Basic Provisions for providing depreciation
  - ▶ Part B – Depreciation on assets covered under special legislations
  - ▶ Part C – Useful Life and other provisions
- ▶ Per Schedule II, depreciable amount is the cost of an asset or other amount substituted for cost, less residual value.
- ▶ Schedule II applicable to financial year commencing on or after April 1, 2014
- ▶ Can a Company having its financial year ending on December 31, 2014 apply the rates prescribed under Schedule II?



# Depreciation

## Implications – Method of depreciation and change therein

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- ▶ Apart from written down value and straight line method, depreciation over number of production or similar units allowed
- ▶ Depreciation expense under units-of-production, based on units produced in the period,
- ▶ Benefits of Units of production (UOP) method:
  - ▶ Better matching of depreciation charge with revenue
  - ▶ Possibility of depreciating an asset faster than is allowed by class life depreciation
- ▶ Disadvantages of UOP method:
  - ▶ Possibility of delaying the start of depreciation and depreciation being stopped if the asset is not in use due to work delays
- ▶ UOP commonly used for Natural Resource Extraction Equipment
- ▶ Implications of changes in the method of depreciation from SLM to UOP
- ▶ Change in method of depreciation is change in accounting policy – Prospective or Retrospective?
- ▶ Disclosures for change in method of depreciation?
- ▶ Consideration for one time depreciation costs in inventory valuation?

# Depreciation

## Overview – Useful Life

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- ▶ Useful life 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
- ▶ There is no restriction on method to be used, hence, WDV can be used as well until the depreciable amount is amortised over its useful life
- ▶ Intangible assets (toll roads) created under BOT, BOOT or any other form of PPP route will be amortized using amortization rate arrived at by dividing actual revenue for the year with total estimated revenue.
- ▶ Rebuttable presumption under AS 26 that useful life of Intangible assets (IA) will not exceed ten years
- ▶ IA can be amortised over higher useful life if persuasive evidence available that useful life will be specific period longer than 10 years
- ▶ A Company may use revenue based amortisation of Built, Operate & Transfer (BOT) assets
- ▶ Companies regulated by other law, e.g., electricity companies - Depreciation rates / residual values prescribed by regulatory body to prevail

# Depreciation

## Overview – Useful Life

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- ▶ Useful lives of fixed assets prescribed under the 2013 Act is different from those envisaged under Schedule XIV e.g.
  - ▶ General furniture and fittings – useful life reduced from 15 to 10 years
  - ▶ Buildings other than factory buildings and other than RCC frame structure - useful life reduced from 58 to 30 years
  - ▶ Continuous Process Plant – Schedule II has originally prescribed life as 8 years, now changed to 25 years. Major relief for companies having such assets
- ▶ Refer comparative chart in next slide
- ▶ Implications of change in Useful life – Prospective or Retrospective?
- ▶ Residual value should not exceed 5% of the value assets unless supported by technical advise
- ▶ Impact of change in residual value should be charged to profit & loss as no transitional provisions prescribed
- ▶ Disclosure of change in useful life and change in estimate

# Depreciation

## Key impact - Change in useful life

(in years)

Asset	Old	New
Buildings RCC Framework	60	60
Buildings other than RCC Framework	60	30
Fence, Wells, Tube wells	30	5
Temporary Structures	1	3
Roads	-	3, 5, 10
Plant & Machinery	20	15
Continuous Process Plants	18	25
Furniture and Fixtures	15	10
Vehicles	10	8
Computers	4	3

# Depreciation

## Overview and key changes

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- ▶ Is the useful life stated in revised schedule II mandatory?
- ▶ Through amendment on August 29, 2014, following options given to the Company, different useful life / Residual value than those prescribed in Part C can be taken, provided:
  - ▶ Disclosure of different useful life / residual value made in the financials
  - ▶ Disclose justification for different useful life / residual value duly supported by technical advise
- ▶ No clarity on whether technical advise can be taken internally by the Company or from independent expert

# Depreciation

## Overview – Transitional Provisions for change in useful life

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- ▶ Transitional provisions
  - ▶ If remaining useful life is not nil, carrying amount of the asset to be depreciated over the remaining useful life
  - ▶ If remaining useful life is nil by applying Schedule II, depreciable amount **may be** adjusted with retained earnings
- ▶ Practical example
- ▶ In case of depreciable amount on transition is adjusted against retained earnings, will it be net of tax?
- ▶ ICAI announcement titled, “Tax effect of expenses/income adjusted directly against the reserves and/ or Securities Premium Account.” The Announcement, among other matters, states as below:
  - ▶ “... Any expense charged directly to reserves and / or Securities Premium account should be net of tax benefits expected to arise from the admissibility of such expenses for tax purposes. Similarly, any income credited directly to a reserve account or a similar account should be net of its tax effect.”
  - ▶ Considering the above, it seems clear that amount adjusted to reserves should be net of tax benefit, if any.

# Depreciation

## Extra Shift Depreciation

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- ▶ The useful lives of assets working on shift basis have been specified in the Schedule based on their single shift working.
- ▶ Extra shift depreciation not applicable to assets marked with “No Extra Shift Depreciation”
- ▶ Asset used for double shift - Depreciation will increase by 50% for such duration
- ▶ Asset used for triple shift - Depreciation will increase by 100% for such duration
- ▶ Earlier the depreciation rates for single, double & triple shift was 4.75%, 7.42% and 10.34%
- ▶ Practical Examples
- ▶ Should extra shift depreciation be computed asset wise / division wise / Company as a whole?
- ▶ Should extra shift be factored while estimating useful life of the assets?
- ▶ If the useful life is estimated based on single shift working, should usage of such assets for extra shift impacts the balance useful life?

# Depreciation Revaluation Reserve

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- ▶ In case of revaluation of fixed assets, companies are currently allowed to transfer an amount equivalent to the additional depreciation on account of the upward revaluation of fixed assets from the revaluation reserve to P&L. Hence, any upward revaluation of fixed assets does not impact P&L.
- ▶ Will the same position continue under the CA 2013 also?
- ▶ Under the 1956 Act, depreciation was to be provided on the original cost of an asset.
- ▶ Schedule II requires depreciation to be provided on historical cost or the amount substituted for the historical cost. Hence, depreciation to be provided on revaluation amount
- ▶ The ICAI Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets allowed an amount equivalent to the additional depreciation on account of the upward revaluation of fixed assets to be transferred from the revaluation reserve to the P&L.
- ▶ No change in the position, as schedule II mandates to charge depreciation on full amount and there is no restriction on withdrawal from reserves
- ▶ What is the status of Revaluation Reserve under Ind-AS 16?



# Depreciation

## Dividend Declaration

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- ▶ Per Section 123, every company shall provide depreciation before declaring dividend
- ▶ Such dividend shall be provided as per schedule II
- ▶ A Company depreciates Plant & Machinery over 20 years, where the useful life is 15 years, whether will it be sufficient compliance for declaration of dividend
- ▶ Earlier, in CA 1956, section 350 states that the depreciation shall be as per the rates provided in schedule XIV. No such reference to rates or useful life is made in S. 123 of the CA 2013
- ▶ The wording in section 123 states that depreciation shall be as per schedule II
- ▶ Schedule II permits different useful life by any Company provided adequate disclosure in financial with justification duly supported by technical advise is made
- ▶ Hence, the depreciation assuming a higher useful life, resulting in lower depreciation and higher profits, shall be sufficient compliance with Section 123

# Depreciation

## Dividend Declaration

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- ▶ Per Section 123, every company shall provide depreciation before declaring dividend
- ▶ Such dividend shall be provided as per schedule II
- ▶ Whether declaring dividend under CA 2013 for earlier financial year, wherein the depreciation is determined as per Schedule XIV is correct?
- ▶ Assume that X Co. Ltd has financial year ending on 30 September 2014
- ▶ The Company has provided depreciation under schedule XIV
- ▶ The Board has proposed dividend in its Board meeting in October 2014
- ▶ The shareholders has approved the dividend in AGM in November 2014
- ▶ Such dividend is proposed and declared under CA 2013, which mandates depreciation as per Sch. II, while the depreciation in this case is per CA 1956
- ▶ Per General Circular 8/2014, depreciation rates and principles prescribed in Schedule II are relevant only for the financial years commencing on or after 1 April 2014
- ▶ Hence, above dividend can be declared since it doesn't relate to financial year commencing on or after 1 April 2014

# Depreciation Managerial Remuneration

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- ▶ Per Section 198, depreciation as per section 123 should be deducted for computing limits of managerial remuneration
- ▶ Section 123 refers depreciation as per schedule II of the CA 2013
- ▶ Assume that X Co. Ltd has financial year ending on 31 March 2015
- ▶ The Company has provided depreciation under schedule II and significant assets has completed its life and its WDV needs to be charged off
- ▶ Option 1 – The Company charge such amount to reserves
- ▶ Option 2 – The Company charge such amount to statement of profit & loss
- ▶ If option 2 is selected, whether entire depreciation charged to profit & loss including one time transition costs will be considered or depreciation for the year will be considered

# Component Accounting

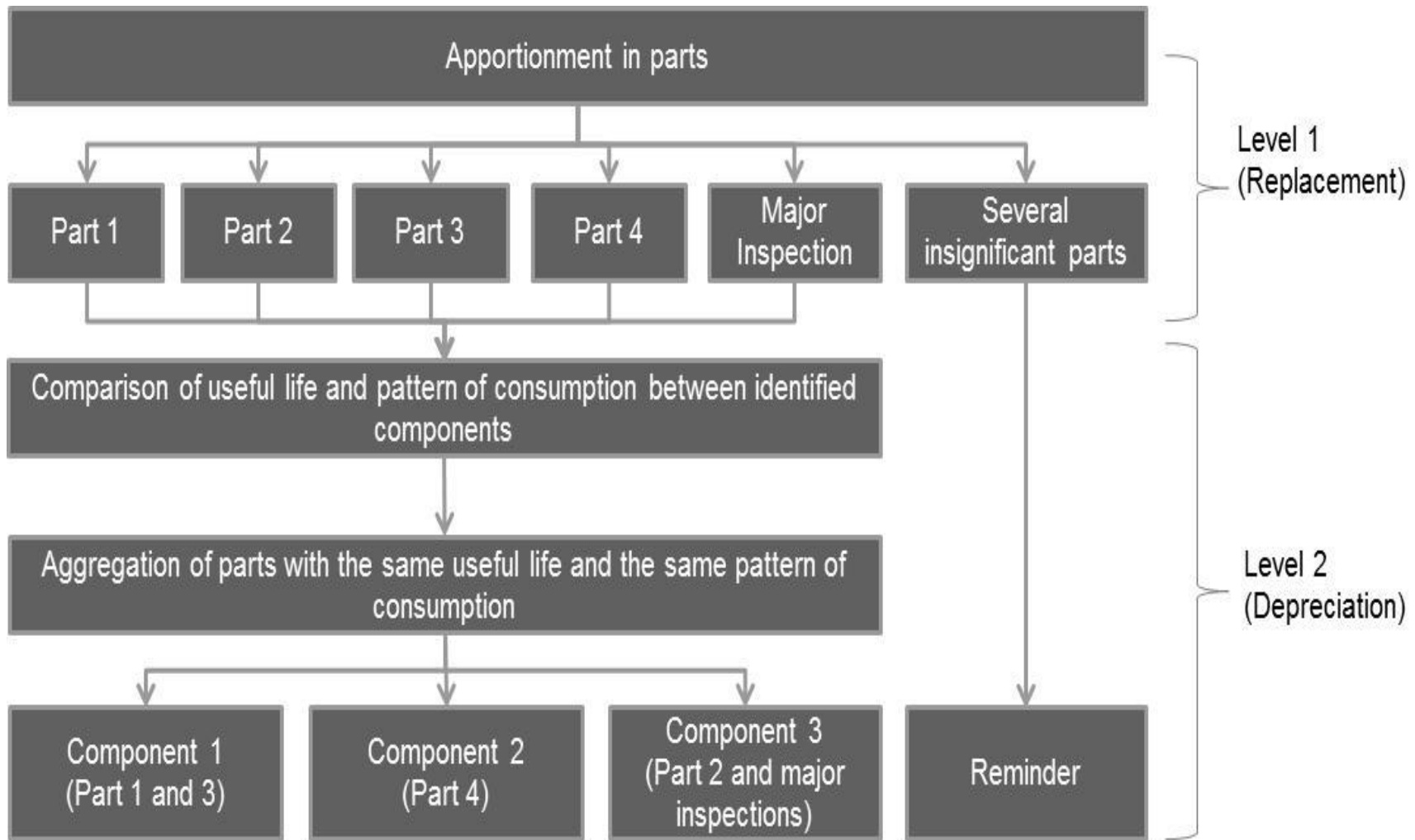


# Component Accounting Overview

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- ▶ Useful life specified in Part C of the Schedule is for whole of the asset.
- ▶ Useful life of significant part shall be determined separately:
  - ▶ Where cost of a part of the asset is significant to total cost of the asset;
  - ▶ useful life of that part is different from the useful life of the remaining asset,
- ▶ Some industries the determination is simple while some industry it is complex process
- ▶ An IT company, which has only computers as fixed assets, may be able to determine with little analysis that there are no significant components requiring separate depreciation.
- ▶ However, for an airline company, it may be clear that engine has different useful life vis-à-vis remainder of the aircraft

# Component Accounting Overview



# Component Accounting Overview

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- ▶ Under this approach, first split the fixed asset into various identifiable parts to the extent possible.
- ▶ The identified parts are then grouped together if they have the same or similar useful life.
- ▶ No need to identify and depreciate insignificant parts as separate components; rather, they can be combined together in the remainder of the asset or with the principal asset.
- ▶ Identification of significant parts is a matter of judgment and decided on case-to-case basis.
- ▶ Identification of separate parts of an asset and determination of their useful life is not merely an accounting exercise; rather, it involves technical expertise.
- ▶ Hence, involve technical experts to determine the parts of an asset.

# Component Accounting

## Materiality for significant component

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- ▶ A company needs to identify only material / significant components separately for depreciation.
- ▶ Materiality is a matter of management / audit judgment and needs to be decided on the facts of each case.
- ▶ Normally, a component having original cost equal to or less than 5% of the original cost of complete asset may not be material. However, a component having original cost equal to 25% of the original cost of complete asset may be material.
- ▶ Also consider impact on retained earnings, current year profit or loss and future profit or loss (say, when part will be replaced) to decide materiality.
- ▶ If a component may have material impact from either perspective, the said component will be material and require separate identification.



# Component Accounting Replacement Costs

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- ▶ The application of component accounting will cause significant change in measurement of depreciation and accounting for replacement costs.
- ▶ Presently, companies need to expense replacement costs in the year of incurrence. Under component accounting, companies will capitalize these costs as a separate component of the asset, with consequent expensing of net carrying value of the replaced component.
- ▶ If it is not practicable for a company to determine carrying amount of the replaced component, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.
- ▶ Even under the component accounting, a company does not recognize in the carrying amount of an item of fixed asset the costs of the day-to-day servicing of the item. These costs are expensed in the statement of profit and loss as incurred.

# Component Accounting

## Major inspection/ overhaul

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- ▶ No specific guidance provided under AS 10 Accounting for Fixed Assets
- ▶ Detailed guidance given in Ind AS 16 Property, Plant and Equipment
- ▶ Major inspection/ overhaul is treated as a separate part of the asset, regardless of whether any physical parts of the asset are replaced
- ▶ When a company purchases a new asset:
  - ▶ Received after major inspected/ overhaul by the manufacturer.
  - ▶ Major inspection/ overhaul is identified separately even at the time of purchase of new asset.
  - ▶ The cost of such major inspection/ overhaul is depreciated separately over the period till next major inspection/ overhaul.
- ▶ Upon next major inspection/ overhaul:
  - ▶ the costs of new major inspection/ overhaul are added to the asset's cost;
  - ▶ any amount remaining from the previous inspection/ overhaul is derecognized.

# Component Accounting

## Major inspection/ overhaul

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- ▶ Cost of the previous inspection/ overhaul was not identified (and considered a separate part) when the asset was originally acquired or constructed.
- ▶ Not necessarily an error but a change in an estimate
- ▶ This process of recognition and de-recognition should take place even in such cases.
- ▶ The company uses estimated cost of a future similar inspection / overhaul to be used as an indication of the cost of the existing inspection / overhaul component to be derecognized after considering the depreciation impact.
- ▶ Major inspection / overhaul charged to profit & loss
- ▶ Under AS 10, all repair expenditure (including major inspection/ overhaul) need to be charged to P&L as incurred
- ▶ Though schedule II mandates component accounting, it does not state that application of component accounting is based on Ind-AS 16 principles
- ▶ The application of component accounting is restricted only to physical parts
- ▶ Neither on initial recognition nor subsequently, the company identifies major inspection/ overhaul as separate component. Rather, any expense on major inspection/ overhaul is charged to P&L as incurred

# Component Accounting

## Transitional provisions

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- ▶ Component accounting was made applicable from 1 April 2014, which has now been deferred to 1 April 2015
- ▶ To be applied to the entire block of assets existing as at that date. It cannot be restricted to only new assets acquired after 1 April 2015
- ▶ Transitional provisions of Schedule II can be used to adjust the impact of component accounting
- ▶ If a component has zero remaining useful life on the date of applicability i.e., 1 April 2015, its carrying amount, after retaining any residual value, may be charged to the opening balance of retained earnings.
- ▶ The carrying amount of other components, i.e., components whose remaining useful life is not nil on 1 April 2015, is depreciated over their remaining useful life.

# Component Accounting

## Disclosures for change in accounting policy

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- ▶ The company has adopted Schedule II to the Companies Act, 2013, for depreciation purposes, from 1 April 2014. The company was previously not identifying components of fixed assets separately for depreciation purposes; rather, a single useful life/ depreciation rate was used to depreciate each item of fixed asset.
- ▶ Due to application of Schedule II to the Companies Act, 2013, the company has changed the manner of depreciation for its fixed assets. Now, the company identifies and determines separate useful life for each major component of the fixed asset, if they have useful life that is materially different from that of the remaining asset. The company has used transitional provisions of Schedule II to adjust the impact of component accounting arising on its first application. If a component has zero remaining useful life on the date of Schedule II becoming effective, i.e., 1 April 2015, its carrying amount, after retaining any residual value, is charged to the opening balance of retained earnings. The carrying amount of other components, i.e., components whose remaining useful life is not nil on 1 April 2015, is depreciated over their remaining useful life.
- ▶ Had the company continued to use the earlier policy of depreciating fixed asset, the profit for the current period would have been higher by INR XXX (net of tax impact of INR XXX), retained earnings at the beginning of the current period would have been higher by INR XXX (net of tax impact of INR XXX) and the fixed asset would correspondingly have been higher by INR XXX.

# Component Accounting

## Industry Impact

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### ▶ Mining and Construction

- ▶ Assets in Mining and Construction industry include heavy duty trucks, vehicles, dozers, excavators, loaders & unloaders, tunnelling machinery, etc.
- ▶ Heavy duty machineries are made up of various assembled parts which are high in value and also have a different useful life as compared to the other parts such as chassis, rollers, body, electrical systems, etc. These items will have to be broken in to their components.
- ▶ Entities will also have to estimate mine restoration liabilities and capitalise with the initial cost of the mine.

### ▶ Commodity manufacturing Industry – Crude, Ore, Power

- ▶ Various facilities that can be identified as first level components such as Water treatment, Gas tapping, Conveyors, Turbines, Rooters, Shafts, Grids, Tankages, Ovens, Casters, Moulds, Furnaces, Rolling mills, etc.. More often one component that is left out in the analysis is the Pipelines, which have material value and different useful life.
- ▶ Entities will need to estimate its asset retirement obligations at the time of initial capitalisation.

# Component Accounting

## Industry Impact

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### ▶ Shipping

- ▶ Main parts of a ship include hull and engine. Further, hull is made up of deck, chassis, propeller, funnel, stern and super structure. A modern ship includes a fair component of electronic and automatic control systems. Entities will have to carry out a detailed exercise and use its judgement for capitalising each component

### ▶ Hotel Industry

- ▶ A restaurant maintains a minimum stock of silverware and dishes. Some entities treat cutlery, crockery, linen, etc, as stores and spares and group them under inventory. Any increase or decrease is accounted as consumption in profit and loss account. Moreover, Schedule XIV does not lay down any rate for depreciating such items and hence companies in India adopt inventory and consumption approach to account these items.
- ▶ For a restaurant, cutlery is similar to a plant, without which it cannot operate. Under Ind AS 6, these items fall into the definition of tangible assets and hence need to be capitalised as such and depreciated based on its useful life. Considering the nature of these assets, the estimation of their useful life may involve a significant amount of judgment.
- ▶ Globally, few Companies depreciates above assets over a period of three years

# Component Accounting

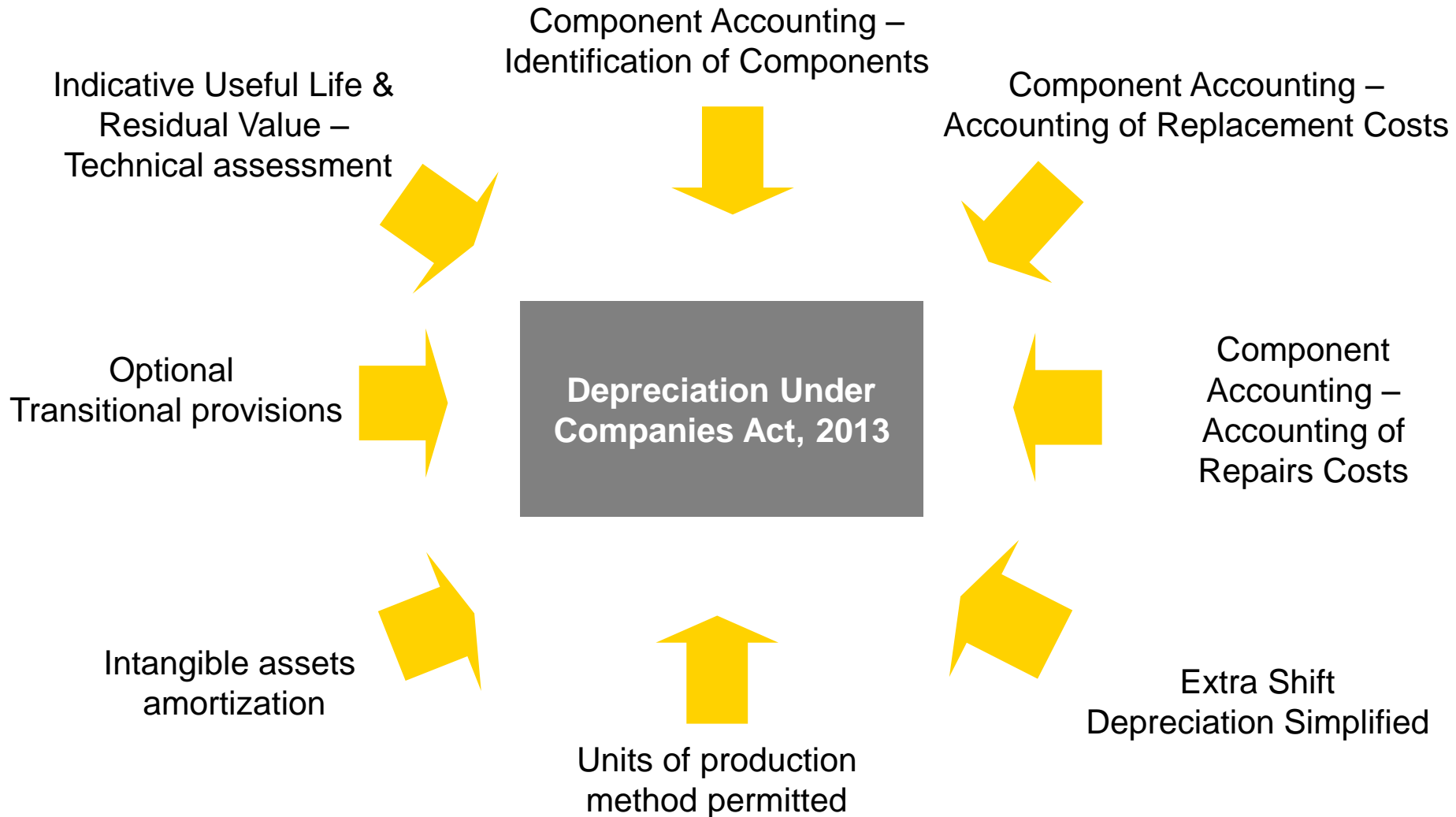
## Industry Impact

- ▶ **Power Manufacturing, Transmission and Distribution**
- ▶ Different useful lives must be applied to 'main grids' and 'sub grids' as well as 'power grids' and 'gas grids';
- ▶ The residual value of the grid is significant due to the need for continuous renewal
- ▶ Useful life is impacted by service concession arrangements with the State Governments

High Voltage Grids	Distribution Grids	
Land – Buildings (for example, buildings for sub-stations) – Technical equipment (for example, protection and measurement equipment, control devices) – Overhead lines (for example, 380/230KV steel) – Cable (e.g. 380/230KV) – Current transformers	Land – Buildings (for example, sub-plant buildings) – Piping – Cable tunnel – Cable – Cables for communication (under / overground) – Open wire (steel, concrete and wood) – Sub-station – without buildings – Sub-station – technical equipment – Power sub-stations – without buildings	– Power sub-stations – technical equipment – Power sub-stations (poles, steel and wood) – Cable for connection to customers – Open wire for connection to customers – Counters and measuring devices – mechanical – Counters and measuring devices – electronic – Mobile power sets



# Conclusion Key Impact



**Questions?**



# Thank you

A photograph showing two individuals in dark business suits. They are standing in front of a window with white vertical blinds. The person on the left is handing a white business card to the person on the right. The card has some text and a logo on it. The scene is brightly lit, suggesting an indoor office or meeting environment.

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