Changes and Challenges

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The Companies Act, 2013 ("the Act") aims to enhance changes in corporate environment and corporate democracy. The Act seeks to consolidate and amend the law relating to the companies taking into consideration best global practices and emerging Indian perspectives.

The provisions governing charge of depreciation in the erstwhile Schedule XIV to the Companies Act, 1956 have been replaced with Schedule II to the Companies Act 2013 effective from 1st April, 2014 vide MCA notification dated 26th March, 2014.

The new approach of calculating depreciation will result in a different amount of depreciation charged to the Income statement as compared to the older approach under the Companies Act, 1956, thereby impacting the bottom line of the companies, positively or negatively.

To quote Leonardo Da Vinci "The noblest pleasure is the joy of understanding". This article is intended to enumerate and elaborate the impact of the new approach against the old approach

Applicability

Companies whose financial statements comply with Sec 133 of the Act, including those companies as may be prescribed by the Central Govt. in the Official Gazette come under the purview of Schedule II of the Act. Transition from "Rate Based" to "Useful Life" – The Paradigm Shift

Schedule II and AS 6 state that depreciation is the systematic allocation of depreciable amount of an asset over its useful life.

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

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

As per the notification dated 27th March, 2014 issued by MCA, companies were categorized into the following classes:

a. Class I: Permitted to adopt useful life other than that prescribed in Schedule II
b. Class II: Adopt useful life as prescribed by the relevant authority
c. Class III: Adopt useful life either equal to or less than that as prescribed in Schedule II

However pursuant to an amendment on 31st March, 2014 the requisite provision reads as follows:

"The useful life of an asset shall not be ordinarily different from the useful life specified in Part C and the residual value of an asset shall not be more than five per cent of the original cost of the asset provided that where a company adopts a useful life different from what is specified in Part C or uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice."

In simple terms, by virtue of the amendments to Schedule II, all companies now have an option of depreciating the assets over their useful life which could be different from the useful life as prescribed in Schedule II. The residual value of the assets could also be different from the five percent threshold prescribed in Schedule II. In case the company uses different useful life or a residual value of more than five percent, it shall disclose such difference and provide justification in this regard in the financial statements. Such justification should also be supported by a technical report.

Harmonious Interpretation of AS 6 & Schedule II

AS 6 states that the depreciation rates prescribed under the statute are bare minimum. If the management's estimate of useful life of an asset is shorter than as envisaged under the act, depreciation may be computed at such higher rate as may be determined by the management.

The contradiction with reference to **"Useful Life"** is explained through the following examples:

- The management has estimated the useful life of an asset to be 10 years. The life envisaged under the Schedule II is 12 years. In this case, AS 6 requires the company to depreciate the asset using 10 year life only. In addition, Schedule II requires disclosure of justification for using the lower life. The company cannot use 12 year life for depreciation. This example explains the overriding effect of AS 6 over Schedule II.

- The management has estimated the useful life of an asset to be 12 years. The life envisaged under the Schedule II is 10 years. In this case, the company has an option to depreciate the asset using either 10 year life prescribed in the Schedule II or the estimated useful life, i.e., 12 years. If the company depreciates the asset over the 12 years, it needs to disclose justification for using the higher life backed up by technical assessment. The company should apply the option selected consistently. This example explains the options available as per Schedule II.

Management Assessment	Schedule II	Conclusion	Disclosure
10 years	12	10 years	Required - 10 years
12 years	10	10 or 12 years	Required - 12 years

The contradiction with reference to Residual Value is explained through the following examples:

Case I

The management has envisaged the life of an asset as per AS 6 and Schedule II to be 10 years. The estimated residual value of the asset is NIL. However as per schedule II, the residual value should not be more than 5% of the cost. In this case, AS 6 depreciation is the **minimum threshold**. The company cannot use 5% of cost as the residual value. In addition, additional disclosure is required for justification of such excess residual value. (Say, a machinery of Rs 100 was purchased on 1st April, 2015. The management estimate of residual value is Rs 3. As per Schedule II, the residual value is up to 5% of cost of the asset i.e. Rs 5. The minimum threshold of residual value would be Rs 3 i.e. the minimum residual value of that asset would be Rs 3 and not Rs 5)

Case II

Alternatively, let us assume that the management has estimated residual value of the asset to be 10% of the original cost, as against 5% value envisaged in the Schedule II. In this case, the company has an option to depreciate the asset using either 5% residual value prescribed in the Schedule II or the estimated residual value, i.e., 10% of the original cost. If the company depreciates the asset using 10% estimated residual value, it needs to disclose justification for using the higher residual value. The company should apply the option selected consistently.

(Say, the same machinery that was purchased on 1st April, 2015 for Rs 100 is estimated to have a residual value of Rs 10 as against Rs 5 required by Schedule II. Here, the management can chose between Rs 10 and Rs 5 as their residual value for computing depreciable amount. If Rs 10 is chosen, the same has to be justified with technical reports)

Details	Amount in INR(Case 1)	Amount in INR(Case 2)
Cost of Machinery	100	100
Management estimated residual value	3	10
Schedule II Residual Value (5%)	5	5
Depreciable Value	97	Range of 90 - 95

Determination of Useful Life

The following are the factors to be considered for determining the useful life of the asset:

a. Expected usage of the asset
b. Expected physical wear and tear. This depends mainly upon the operational factors such as number of shifts for which the asset is to be used and the repair & maintenance program etc.
c. Technical and commercial obsolescence arising from changes or improvements in production
d. Legal or similar limits in the usage of the asset

It is however important to know that the useful life of the asset may be shorter than the future economic benefits embodied in the asset.

Various Methods envisaged:

- Part A – The number of production or similar units expected to be obtained from the Asset by the entity
- Part B – Useful life or Residual Value of any specific asset as notified for accounting purposes by a Regulatory Authority
- Part B – Useful life or Residual Value of any specific asset as notified for accounting purposes by the Central Government
- Part C – Estimated Useful as indicated based on the nature of assets.
- AS 6 – Based on Type of Asset, Nature of its use and Circumstances prevailing in the Business.

Units of Production method

The erstwhile Schedule XIV did not expressly allow depreciation to be provided based on "Units of Production" method. However, based on the definition of "useful life" as specified in AS 6, units of production (UoP) method was allowed. It is important to note the circular issued by MCA dated 21st February 2003, where based on representations made by various companies engaged in the production of steel to prescribe an appropriate method for depreciation, the department clarified that the usage of UoP method may tend to manipulate profits based on a particular set of assumptions and technical opinion. Therefore, companies were not allowed to follow UoP Method It is also interesting to note that the Expert Advisory Committee (EAC), based on a query (EAC-Vol – XVII – 1.27) allowed depreciation based on flying capacity and usage plan of the Helicopters. However, the life of the Helicopters as per the flying capacity and usage plan was 6 years as against 17 years under erstwhile Schedule XIV.

The notified Indian Accounting Standard 16 on Property, Plant and Equipment (Para 55) allows UoP method of depreciation and also specifies that under this method, the depreciation charge can be ZERO while there is no production.

In conclusion, since the Schedule II expressly allows usage of UoP method, the Companies may adopt this method provided, the useful life is lesser than that specified in schedule. This also satisfies the AS 6 requirement that specifies that depreciation rates prescribed under the statute (Schedule II estimated life) are bare minimum.

Useful life or Residual Value notified by a Regulatory Authority

Part B of Schedule II allows depreciation to be computed based on useful life or residual value if such life is notified by Regulatory Authority. A typical example is the company involved in the production power. These companies are governed under Electricity Act, 2003, wherein powers are provided to regulatory commissions to regulate/determine tariff for supply of electricity. Accordingly, the Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2014 prescribes depreciation rates to be followed. The MCA had issued a circular dated 31st May 2011 that, for the Companies engaged in generation/supply of power, the provisions of Companies Act will apply to the extend they are not inconsistent with the Electricity Act. Keeping this in view, the depreciation methods specified in Electricity Act will prevail over the methods specified in the Companies Act.

Useful life or Residual Value notified by a Central Government

Part B of Schedule II allows depreciation to be computed based on useful life or residual value if such life is notified by Central Government. The Central Government by orders may specify rates or useful life, accordingly the depreciation is to be computed.

Estimated Useful as indicated based on the nature of assets

Part C of Schedule II provides useful life of tangible assets based on its nature. The erstwhile Schedule XIV classified the assets into 4 major categories, whereas, the Schedule II has classified the assets into 15 categories.

Depreciation based on Type of Asset, Nature of its use and Circumstances prevailing in the Business

Para 12 of AS 6 specifies that the most commonly used methods are straight line and reducing balance methods. However, the management can select the most appropriate method based on various important factors like:

- Type of Asset
- Nature of use of Asset
- Circumstances prevailing in the business

This para provides flexibility to apply methods based on the economic factors prevailing in the business. However, it is prudent to apply a consistent methodology to enable appropriate presentation of financial statements.

Depreciation of Intangible Assets

Schedule II states that in respect of Intangible Assets, the provisions of the Accounting Standards applicable for the time being in force shall apply.

As per the amendment issued by MCA dated March 31, 2014 to Schedule II, a company may use revenue based amortization method for Build, Own, Transfer (BOT), Build, Own, Operate, Transfer (BOOT) assets or other form of Public Private Partnership (PPP) assets.

Para 63 of AS 26 clarifies that the depreciable amount of an intangible asset should be allocated over the useful life of such intangible asset. AS 26 takes a rebuttable presumption that the useful life of an intangible asset would normally not exceed 10 years from the date such asset is available for use.

Amortization commences when the asset is available for use.

The management may however chose a different useful life of such intangible asset based upon the following factors:

- Expected usage in terms of efficiency and effectiveness of such asset
- Typical product life cycle of such asset
- Technical and technological advances
- Expected actions by competitors or potential competitors
- Level of maintenance required to obtain the estimated future economic benefits from such asset
- The period of control over such asset
- Dependence of useful life on the useful lives of other assets

Example:

An enterprise has purchased an exclusive right to operate a toll motorway for thirty years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least thirty years.

The enterprise amortizes the right to operate the motorway over thirty years, unless there is evidence that its useful life is shorter.

Residual value Intangible assets:

The Residual value of an intangible asset is taken as zero unless:

a. There is a commitment by a third party to purchase the asset at the end of the useful life or
b. There is an active market for the asset such that:
  - Residual value can be determined based upon the market
  - It is probable that such market shall subsist at the end of the useful life of such asset(s)

Component Accounting

As per Note 4 of Schedule II specifies that Useful life specified in Part C of the Schedule 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. Companies will need to identify and depreciate significant components with different useful lives separately.

The application of component accounting is likely to cause significant change in the measurement of depreciation and accounting for replacement costs.

Currently under the present accounting system, companies need to expense replacement costs in the year of incurrence while under the component accounting, companies will capitalize these costs and depreciate it over the useful life of that component.

MCA vide amendment notification dated 29th August, 2014 states that the companies may adopt the component accounting approach voluntarily from 1st April, 2014 onwards and the same shall be mandatory from 1st April, 2015. This notification was issued based upon the requests from companies regarding the difficulty in adopting the component accounting immediately from financial year 2014-2015.

Example:

If a major part of a turbine in a thermal power plant is to be replaced, the same would as per para 12.1 of AS 10 be expensed off with the prorogation that it does not increase the future benefits from the existing asset beyond its previously assessed standard of performance at the time of purchase, however, as per component approach of accounting, the component would be capitalized with the original asset and be expensed off based upon the components useful life.

Double & Triple Shift Working

Schedule XIV to Companies Act, 1956 stated various rates for single, double and triple use of assets. Under Schedule II to Companies Act, 2013 no such rates are prescribed for extra shift working. Schedule II states that for the period of time, the asset is used for doubt shifts, its depreciation shall increase by 50% and for triple shift by 100%.

Transitional Provision

The provisions of Schedule II came into effect from 1st April, 2014. The carrying amount of the asset as on that date:

- Shall be depreciated over the remaining useful life of the asset.
- After retaining the residual value, the carrying amount "shall be" recognized in the opening balance of retained earnings where the remaining useful life of the asset is nil

MCA's amendment notification dated 29th August, 2014 requires replacement of the term "shall be" with the term "may be", thereby providing option to Companies to either adjust the carrying amount to be recognized in the opening balance of retained earnings or charged to the current year profit and loss account.

Companies may use the fairly simple Straight line method (SLM) of depreciating the asset over the remaining useful or can adopt the Written down value (WDV) method.

If the Company adopts WDV methods, it needs to compute an effective depreciation rate using the following formula:

R= {1 – (s/c) ^1/n} x 100

Where R = Rate of Depreciation (in %)
n = Remaining useful life of the asset (in years)
s = Scrap value at the end of useful life of the asset
c= Cost of the asset/Written down value of the asset

Example:

Particulars	Amount (Rs)
Cost of an Asset	100
Residual Value (5%)	5
Depreciable Amount	95
{1-(s/c)}	1-[5000/95000] which is 0.95
{1-(s/c)}^1/n {(n-1) from year 2 onwards}	19%

The effective rates would vary every year based upon the useful life, however the depreciation amount would be the same.

The Effect of Transition from Schedule XIV to Schedule II

Consider a Company purchased a Plant 3 years prior to the commencement of Companies Act 2013 with an estimated useful life of 15 years. The Plant was used for three shifts for three years. Under the erstwhile Schedule XIV, the depreciation rates for single, double and triple use are 4.75%, 7.42% and 10.34% respectively, resulting in a depreciation of 31.02% of the value. The key challenge the company would be to determine the unexpired useful life of the Plant.

Three probable scenarios emerge:

Scenario 1: Unexpired useful life of 12 years (i.e. 15 years less 3 years). This would be on the assumption that the asset worked for 3 whole years without rendering any bias on the number of shifts it worked.

Scenario 2: Unexpired useful life of 9 years (i.e. 15 years less 6 years). This would be on the assumption that the plant would be depreciated in excess of 100% for that period. That is, the plant depreciates 3 years on single use, 4.5 years on double use and 6 years on triple use.

Scenario 3: Unexpired useful life of 6 years (i.e. 15 years less 9 years). This would be on the assumption that each year of use, would equally deplete the life of the asset (One year of triple shift depreciation is equivalent to 3 years of depreciation). Therefore, triple use for a period of 3 years would deplete the life of the asset by 9 years.

Details	Scenario 1	Scenario 2	Scenario 3
Estimated Useful Life	15	15	15
Expired Useful Life	3	6	9
Unexpired Useful Life	12	9	6
Remarks	Not considering impact of wear & tear on 3 shifts	Considering impact of wear & tear on 100% of Expired Useful Life	Considering that each shift depletes life equally

However this issue has been addressed by Schedule II with its flexibility over the useful life of the asset, whereby, the management has the option to decide upon the useful life of such plant & machinery through technical assessments and suitably disclose them.

Charging of Depreciation in case of Revaluation

Under erstwhile Act, depreciation was to be provided on the original cost of the asset. Considering this, ICAI in its ‘Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets’ allowed an amount equivalent to the additional depreciation on such revaluation to be charged off against such reserve.

However as per Schedule II, depreciation is required to be charged on historical cost or on the amount substituted for historical cost. Therefore in case of revaluation the company needs to charge depreciation on the revalued amount and recouping depreciation from revaluation reserve would not apply. Balance of revaluation reserve should be treated as per requirements of AS 10.

Details	Erstwhile Provision Amt in Rs.	Current Provision Amt in Rs.
Original Cost (1st April 2012)	100	100
Depreciation @ 10%	10	10
Depreciation for 2 years	20	20
WDV (1st April 2014)	80	80
Revalued Cost	120	120
Revaluation Reserve	40	40
Current year Depreciation	10	12
Additional Depreciation on Revaluation	4	0
Total Depreciation	14	12
Closing WDV	106	108
Closing Revaluation Reserve	36	40

Conclusion

There are several challenges in the application of the new provisions of depreciation. Each and every asset in the fixed assets register is to be thoroughly reviewed and scrutinized for the purpose of identification of their useful lives which involves huge operational costs and time. Involvement of technical experts in the area of fixed assets review is inevitable and the industry would indeed have a closer look at peer companies to understand the methodology adopted. Ultimately what matters is the consistency in reporting, after all, the purpose of a regulation is to bring uniformity in the reporting practices.

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