Component Accounting - Reference: Section 123 and Schedule II of Companies Act 2013 and Ind AS 16.
Background

Recently component accounting was in much debate and has become part of Indian rules and regulations by taking place in Companies Act 2013 and in Ind AS. The component approach is already allowed under current AS 10, paragraph 8.3. Under AS 10, there seems to be a choice in this matter; however, the Companies Act, 2013 requires application of component accounting mandatorily when relevant and material.

Definition

- As per note 4 Schedule II to the Companies Act, 2013 -“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.”
- As per the amendment dated August 29, 2014 notified by the MCA, the said requirement shall be voluntary in respect for the financial year commencing on or after the April 1, 2104 and mandatory for financial statements in respect of financial years commencing on or after April 1, 2015.
- Under ‘component accounting’, companies will need to identify and depreciate significant components with different useful lives separately
- The component approach is already allowed under current AS 10, paragraph 8.3. Under AS 10, there seems to be a choice in this matter; however, the Schedule II requires application of component accounting mandatorily when relevant and material.
Determination of Cost

- The determination as to whether a part of an asset is significant requires a careful assessment of the facts and circumstances. This 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; and
  - Consideration of potential impact of componentisation on the depreciation expense.

Component accounting requires a company 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, 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 part. When it is not practicable to determine the carrying amount of the replaced part, the cost of the replacement may be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

Transitional Provision

- Component accounting is required to be done for the entire block of assets as at 1 April 2014 if a company opts to follow it voluntarily and as at 1 April, 2015 mandatorily. It cannot be restricted to only new assets acquired after 1 April 2014 or 1 April, 2015 as the case may be.
- As component accounting was hitherto not mandatory in India, it is possible that the separate cost of each significant component of an asset is not available in the books of accounts. In order to determine the cost of such component following criteria can be used:
  - Break up cost provided by the vendor
  - Cost break up given by internal/external technical expert
  - Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset
Procedure

The first step is to identify key components requiring separate depreciation. Schedule II requires separate depreciation only for parts of an item of tangible fixed asset having

- Significant cost, and
- Different useful lives from remaining parts of the asset.

Following diagram depicts a method for bifurcating Fixed Assets into major components-

The company must split the fixed asset into various identifiable parts to the extent possible. The identified parts should be grouped together if they have the same or similar useful life for the purpose of separate depreciation. Insignificant parts may be combined together in the remainder of the asset or with the principal asset.
For instance:

A Building may be split up into the following components -

- Structural design
- Elevators
- Heating system
- Water system
- Electrical system

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, it may be necessary to involve technical experts to determine the parts of an asset.

**Materiality**

A company needs to identify only material/ significant components separately for depreciation.

Materiality is a matter of judgment and needs to be decided on the facts of each case. For example: a component having original cost equal to or less than 5% of the original cost of an asset may not be material. Similarly, a component having original cost equal to 25% or more of the original cost of complete asset may be material. The Company may consider 10% of original cost of the asset as a threshold to determine whether a component is material /significant. In addition, a company also needs to 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.

Each significant component of the asset having useful life, which is different from the useful life of the remaining asset, should be depreciated separately. If the useful life of the component is lower than the useful life of the principal asset as per Schedule II, such lower useful should be used. On the other hand, if the useful life of the component is higher than the useful life of the principal asset as per Schedule II, the company has a choice of using either
the higher or lower useful life. However, higher useful life for a component can be used only when management intends to use the component even after expiry of useful life for the principal asset.

To illustrate, assume that the useful life of an asset as envisaged under the Schedule II is 10 years. The management has also estimated that the useful life of the principal asset is 10 years. If a component of the asset has useful life of 8 years, Ind AS 16 requires the company to depreciate the component using 8 year life only. However, if the component has 12 year life, the company may depreciate the component using either 10 year life as prescribed in the Schedule II.

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