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Business Process Solution Alert

Accounting Insights

Depreciation under Companies Act, 2013
Reference: Section 123 and Schedule II of Companies Act, 2013 & Application Guide on the Provisions of Schedule II to The Companies Act, 2013 issued by ICAI

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Background

Companies Act 2013 has come up with a significant change in the Depreciation rules vide MCA Notification dated 26th March 2014 which has been made effective from 1st April 2014. Schedule II to the Companies Act, 2013 requires depreciating the asset over its useful life unlike Schedule XIV of the Companies Act, 1956 which specifies minimum rates of depreciation to be provided by a company. Before discussing anything further let's have a look on the major changes introduced by Schedule II of the Companies Act, 2013.

Overview of some key changes in schedule ii to the companies act 2013:

- Companies Act 1956 does not deal with amortization of Intangible Assets but New Schedule II to Companies Act 2013 has notifies accounting standard to govern the same.
- Schedule II to Companies Act 2013 has done away with rates of depreciation and has introduced concept of Useful life.
- The depreciable amount of an assets is the cost of an asset or other amount substituted for cost, less its residual value.
- Component Accounting and useful life of a significant part of an asset to be determined separately
- The concept of 100% depreciation of assets whose cost is under 5,000 INR has deleted.
- Companies are allowed to follow different useful lives/residual value if an appropriate justification is given supported by technical advice.

SCHEDULE II

Useful life: Tangible Assets

Schedule II of the Companies Act and AS 6 state that Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.

The 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.

Further in Schedule II originally notified on March 27, 2014, all companies were divided into three classes but Pursuant to a recent amendment to Schedule II notified on March 31, 2014, the Distinction between class (i) and class (iii) has been removed. Rather, the provision now reads as under:

"The useful life of an asset shall not be longer than 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 uses a useful life or residual value of the asset which is different from the above limits, justification for the difference shall be disclosed in its financial statement."

From the use of word "different", it seems clear that both higher and lower useful life and residual value are allowed. However, a company needs to disclose justification for using higher/lower life and/or residual value in financial statement and such disclosure/Justification should be supported by Technical advice.

The requirement is explained in below example

- 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.
- 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. The company should apply the option selected consistently.

Useful life or residual value governed by other regulatory authority shall prevail Schedule II of Companies Act 2013 (Part B of Schedule II). For example: The MCA had issued a General Circular dated 31 May 2011, which states that for companies engaged in generation/supply of electricity, rates of depreciation prevail over the Schedule XIV to the Companies Act. Accordingly, in accordance with Part B of the schedule II, electricity companies will still continue to charge depreciation in accordance with the Electricity Act.

Useful life: Intangible Assets

Schedule II provides a manner in which amortisation of intangible assets (Toll Roads) created under 'Build, Operate and Transfer' (BOT), 'Build, Own, Operate and Transfer' (BOOT) or any other form of Public Private Partnership (PPP) route in case of road projects can be done. A company may use revenue based amortization for BOT assets. For amortization of other intangible assets, AS 26 needs to be applied.

Component Accounting

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.

This requirement is similar to that specified in Ind-AS. Currently under the present accounting system, companies need to expense such costs in the year of incurrence while under the component accounting, companies will capitalise these costs and depreciate it over the useful life of that component.

Transitional Provision

From the date the new regulations come into effect, the carrying amount of an asset on that date:

- Shall be depreciated over the remaining useful life of the asset prescribed in Schedule II of the Companies Act, 2013; or
- After retaining the residual value, shall be recognised in opening retained earnings where the remaining useful life of the assets is Nil.

Illustration A: A Company acquired a building other than factory building and RCC frame structure at a cost of INR 100 lakh on 01.04.2000. The company is depreciating the building as per rate provided in Schedule XIV of 1956 Act i.e., 1.63%. Now Schedule II of 2013 Act became effective from 1st April 2014 in which useful life for this building is specified 30 years.

Now as on 01.04.2014
Original cost: INR100 lakh
Depreciation up to 31st March 2014: INR100 lakh*1.63%*14 years = INR 22.82 lakh
Carrying value of the asset: INR77.18 lakh
The carrying value as on 1st April 2014 will be depreciated over the remaining life of the asset as per Schedule II which is (30-14) 16 years, hence, depreciable amount of INR 77.18 lakh will be depreciated over 16 years and the annual depreciation from FY 2014-15 would be INR 4,51,125 [INR 72.18 lakh (INR 77.18 lakh – 5 Lakhs (100 Lakhs * 5%) /16 years]

Illustration B: Suppose in above example, that building was acquired on 01.04.1982. In this case, the situation would be as follows:

Original cost: R100 lakh
Depreciation up to 31st March 2014: R100 lakh*1.63%*32 years = R52.16 lakh
Carrying Value of the asset: R47.84 lakh
Since useful life of the asset is 30 years and the asset has already been depreciated for 32 years, hence, the carrying amount excluding residual value as on 1st April 2014 will be adjusted with opening retained earnings of 2014-15 and no depreciation will be levied in prospective years

Contradiction between Depreciation

Provisions As Per Schedule II and Accounting Standard 6 There is a contradiction between transition provisions prescribed in the Companies Act, 2013 and provisions of change in method of depreciation contained in Accounting Standard (AS)-6 “Depreciation Accounting”. Now there are two aspects which need to be considered at the time of application of Schedule II:

- Accounting Standard (AS) 6 provides that in case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the

statement of profit and loss while as per Schedule II, where remaining life of the asset is Nil then the carrying amount of assets after retaining residual value should be adjusted with opening balance of retained earnings.

Example: An electric equipment was purchased on 1st April 1998 for INR10, 00,000. Its accumulated depreciation as on 31st March 2014 is INR 8,44,800 considering the rate of depreciation @ 5.28% and WDV is INR 1,55,200 with remaining life of 2 years.

Now as per Schedule II of the Companies Act, 2013, useful life of electric equipment is 10 years. So, INR1,05,200 (INR1,55,200- 5% of INR10,00,000) will be adjusted with opening retained earnings while AS 6 requires that INR1,05,200 should be charged in profit and loss account of FY 2014-15.

- As per aforesaid accounting standard, the deficiency or surplus arising from retrospective computation of depreciation in case of change in method should be adjusted in the accounts in the year in which the method of depreciation is changed but on the other hand Schedule II provides that the carrying amount of assets shall be depreciated over the remaining useful life of the asset.

Example: Suppose a machine of INR 50 lakh was purchased on 1st April 2000. Its accumulated depreciation as on 31st March 2014 is INR 36.96 lakh considering the rate of depreciation @5.28% and WDV is INR 13.04 lakh with remaining life of 4 years.

Now Schedule II specifies the useful life of the same machine 25 years and as per its provision, remaining WDV should be depreciated over the remaining life of 11 years while AS 6 provides that retrospective calculation is to be done in case of change in method and resultant difference should be charged in the profit and loss account of FY 2014-15.

While as per preface to the AS issued by ICAI, if a particular accounting standard is not in conformity with the law, the provisions of the said law or statute will prevail over that accounting standard. Therefore, considering this provision, we can say that transition provisions given under the Companies Act, 2013 will prevail over accounting standard (AS) 6.

Conclusion

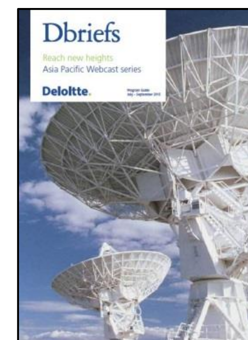
In light of above provision there are certainly various difficulties in applying the new provisions but it will have huge impact on the profit and loss of any enterprise. The useful life of assets having the nature of ‘plant and machinery’ has been increased from 18 years to 25 years and in respect of depreciation rates, it has been changed from 5.28% to 3.80%. Specially, manufacturing industries have more than 70% assets in the nature of plant and machinery, so there will be major change in amount of depreciation to be charged in profit and loss statement in comparison to previous years.

On the other hand, it can be construed that it will increase profits of manufacturing industries because less depreciation will be charged in profit and loss account due to application of the new provisions. As far as tax treatment is concerned, there will not be any impact in respect of depreciation allowance in arriving at taxable income because a separate method of calculating depreciation on the basis of block of assets is used under Income Tax law for the purpose of computing allowable expenditure.

Upcoming Dbriefs - Register

India's Finance Act and Recent Developments: The Road Ahead

Tuesday, 28 July, 2:30 PM – 3:30 PM IST



The proposals of the Indian Finance Act 2015 are now in force and there are significant developments for foreign investors. In addition to the amendments in law by the Finance Act, there have been several other developments on the tax front. What are the amendments in law and recent developments you need to be aware of? Stay up to date with the latest international tax developments in India.

Register now

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