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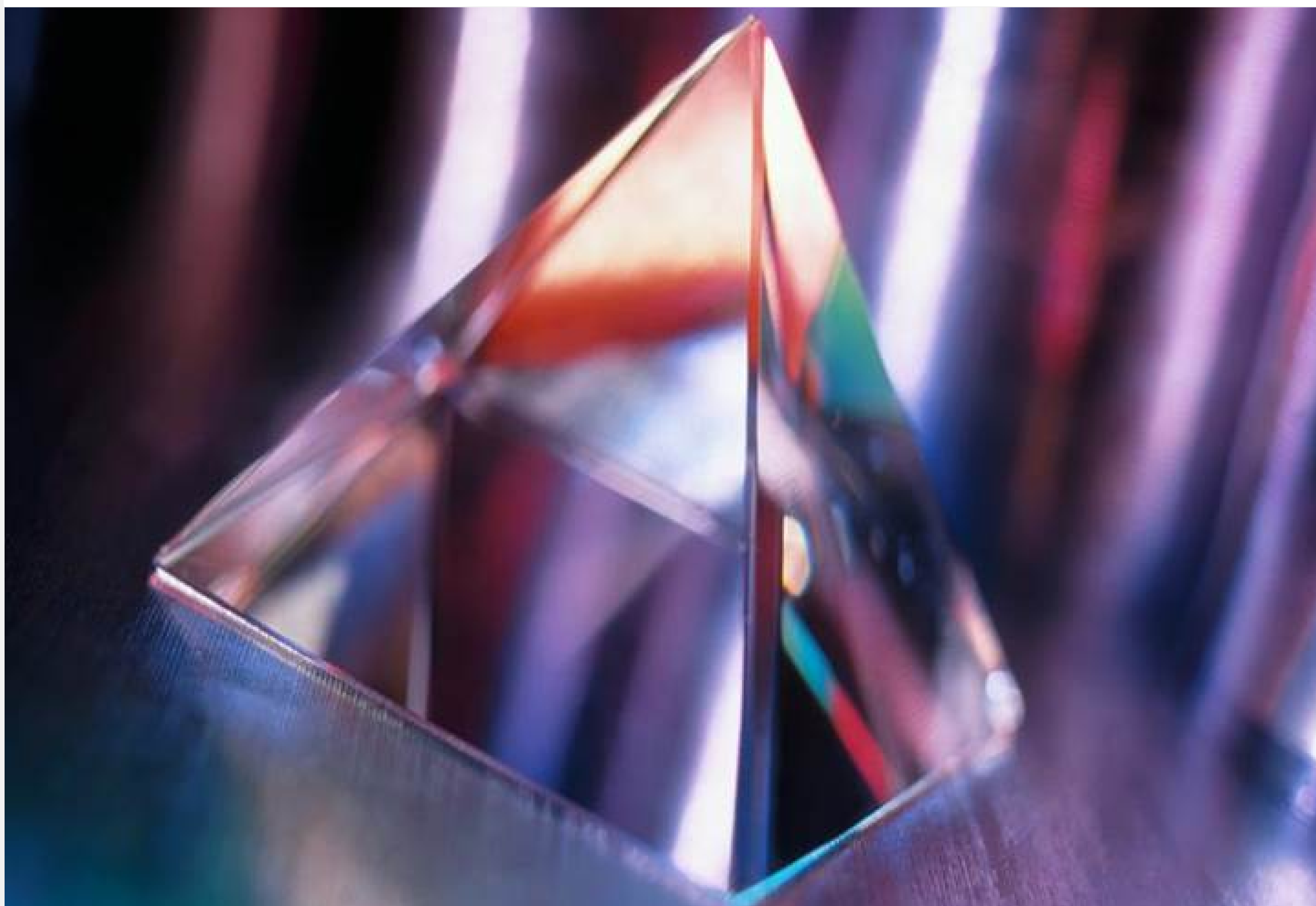

D'Prism

A series on the Companies Act, 2013

Depreciation

Overview

Depreciation under the Companies Act, 2013 (the '2013 Act') is expected to have a pervasive impact; significant amongst which would be determination of profits, earnings per share and managerial remuneration. The collateral impact would be felt on other items such as limits for overseas direct investment by companies, extent of reserves that would be available for buy back of shares, etc. While there may not be immediate answers to various issues that a company may be confronted with, in this issue we discuss the impact that depreciation under the 2013 Act may have on a company's financial statements and operations.

Before we discuss any further, it is necessary to touch upon the key concepts introduced in Schedule II (as amended) to the 2013 Act. This Schedule replaces Schedule XIV to the Companies Act, 1956 (the '1956 Act') with effect from 1 April 2014. The table below highlights the key differences:

Particulars	Schedule II to the 2013 Act	Schedule XIV to the 1956 Act
Definition of the term 'depreciation' and 'depreciation amount'	Systematic allocation of the depreciable amount of an asset over its useful life. Depreciable amount is cost of an asset or other amount substituted for cost, less its residual value.	Not defined.*
Model of depreciation	Useful life regime.	Rate regime.
Definition of useful life	Period over which an asset is expected to be available for use, or the number of production or similar units expected to be obtained from the asset by the entity.	Not defined.*
Intangible Assets	The provisions of the Accounting Standards applicable for the time being in force to apply, except that for intangible assets (toll roads) created under any form of public-private partnership, amortisation may be done using a revenue based model or in accordance with any method as per applicable Accounting Standards. Where a method as specified in Accounting Standards is used, disclosure of the same should be made. Schedule II makes it amply clear that a revenue based amortisation model will be available only in the case of road projects that are created under any form of public- private partnership and not for any other intangible assets.	Intangible assets (toll roads) created under public-private partnership requires amortisation using a revenue model. No mention regarding applicability of Accounting Standards for other intangible assets in Schedule XIV. However, other intangible assets would be covered under the provisions of the Accounting Standards.

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April 2014

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Shift based depreciation	Useful lives have been determined on the basis of single shift. For assets working on double shift, depreciation will increase by 50 percent and in case of triple shift working by 100 percent in respect of specified assets.	Separate rates provided for single, double and triple shifts in respect of specified assets. The calculations of the extra depreciation for double and triple shifts working is to be made separately in the proportion which the number of days for which the concern worked double or triple shift, as the case may be, bears to the normal number of working days during the year.
Assets costing less than Rs. 5,000	No such concept.	Depreciation at the rate of 100 percent.
Depreciation on revalued assets	Entire charge to the Statement of Profit and Loss.	Depreciation to be provided considering the original cost of the asset. Incremental depreciation on revalued portion could be adjusted against revaluation reserve by transfer of an equivalent amount to the Statement of Profit and Loss based on the Guidance Note of the Institute of Chartered Accountants of India.

* The corresponding provisions in Accounting Standard (AS) 6, Depreciation Accounting are applicable, which are similar to the provisions of the 2013 Act.

Useful lives

The useful lives of assets should, generally, not be longer than those specified in Part C of Schedule II. Justification will be required to be given in the financial statements, if a useful life other than that stated in Schedule II is used. It may be noted that Schedule II requires this justification whether the useful life considered is either longer or shorter than that specified in the Schedule. In the 1956 Act, the usage of rates which were, in essence, increasing the useful lives was not permitted.

It may be noted that as per paragraph 13 of AS 6, Depreciation Accounting, where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute (Companies Act), the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute,

depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute i.e., by stating the justification for considering the higher useful life for the asset in the financial statements.

There is a significant decrease in the useful life and consequently an increase in the rate of depreciation for commonly used assets except for continuous process plants and certain special types of plant and machinery (e.g. those used in glass manufacturing, mines and quarries, etc.) under the 2013 Act. For the limited purpose of the table below, the useful lives prescribed by Schedule II have been converted into a deemed rate (assuming a 5 percent residual value) to facilitate comparison with the 1956 Act.**

Nature of asset – illustrative [Single shift working]	2013 Act		1956 Act SLM *	Increase / (decrease)	% change
	Useful Life	Deemed rate SLM*			
General plant and machinery other than continuous process plant	15	6.33%	4.75%	1.58%	33.26%
Continuous process plant	25	3.80%	5.28%	(1.48)%	(28.03)%
General furniture and fittings	10	9.50%	6.33%	3.17%	50.08%
Office equipment	5	19.00%	4.75%	14.25%	300.00%
Desktops, laptops, etc.	3	31.67%	16.21%	15.46%	95.37%
Electrical installations and equipment	10	9.50%	4.75%	4.75%	100.00%

* Straight Line Method

** For the purposes of calculation of depreciation of any specific asset as notified for accounting purposes by a Regulatory Authority, the useful life and residual value shall be as specified therein, irrespective of the requirements of Schedule II. Therefore, more detailed considerations will apply while computing the depreciation for companies in the power or other regulated sectors.

Many capital intensive companies using continuous process plants are likely to see amortisation over longer periods for a significant part of their equipment. For most other assets and other companies, there is likely to be a significant increase in depreciation. Accordingly, companies may see material changes in depreciation relating to asset classes.

Method of depreciation

Schedule II does not specify the method of allocating depreciation over the useful life of the asset. AS 6, Depreciation Accounting states that the most commonly employed methods are the SLM and the reducing balance, also referred to as the written down value (WDV) method. Accordingly, a company may follow the SLM or the WDV method or any other method of depreciation such that the asset (net of its residual value) is depreciated over its useful life and the method reflects the economic benefits flowing from the asset. Different methods may sometimes be used for different sub-classes of assets by a company.

While it is relatively simple to calculate a rate of depreciation based on the useful life following the SLM, calculation of a rate of depreciation using the WDV method may be slightly more complex. Determination of residual value of an asset is normally a difficult matter and requires estimation; however, the 2013 Act stipulates that the residual value should not exceed 5 percent of the original cost of the asset. Use of any other residual value will warrant a disclosure in the financial statements with justification.

The following table illustrates the effect of change in rates from a WDV rate of 40 percent and SLM rate of 16.21 percent under the 1956 Act, on an asset cost of Rs. 1,000 and having a 5 percent residual value, to a new useful life of 3 years under the 2013 Act. For determining the WDV rate under the 2013 Act, a

computation would be required to arrive at the rate (63 percent in the current example), which would depreciate the asset to 95 percent of the cost.

	Depreciation charge and WDV as per 1956 Act				Depreciation charge and WDV as per 2013 Act			
Beginning of	Written down value under WDV method	Depreciation charge as per WDV method @ 40%	Written down value under SLM method	Depreciation charge as per SLM method @16.21%	Written down value under WDV method	Depreciation charge as per WDV method @ 63%	Written down value under SLM method	Depreciation charge as per SLM method @ 31.67%
Year 1	1000	400	1000	162	1000	630	1000	317
Year 2	600	240	838	162	370	233	683	317
Year 3	360	144	676	162	137	87	366	316
Year 4	216	86	514	162	50		50	
Year 5	130	52	352	162				
Year 6	78	28	190	140				
Year 7	50		50					

Componentisation

AS 10, Accounting for Fixed Assets recognises that in certain circumstances, the accounting for an item of fixed asset may be improved if the total expenditure thereon is allocated to its component parts, provided they are in practice separable, and estimates are made of the useful lives of these components. The 2013 Act mandates that where the cost of a part of an asset is significant to the total cost of the asset and the useful life of that part is different from the useful life of the remaining asset, the useful life of that significant part should be determined separately.

The approach of depreciating separate parts of a single item of property, plant and equipment is easily understood in relation to the physical components of a single item. There will, however, also be 'parts' that are less tangible. An entity may purchase an item of property, plant and equipment comprising of separate parts that may be required to undergo major inspections or overhauls at regular intervals over their respective useful lives. Such separate components may have to be isolated when the asset is acquired, and depreciated over the respective periods to the next overhaul. The identification of these inherent components at the time of acquisition may not be simple, because they will generally not have been separately invoiced. Therefore, an estimate of the cost will be required. This will generally be based on the current cost of the expected overhaul or inspection (i.e. the estimated cost of those activities if they were performed at the time of the purchase).

That having been said, identification of significant components of an asset requires a careful assessment of the facts and circumstances and involves use of professional judgment. While most assets would have components, and some components may have a useful life that is significantly different than the main asset, the company should consider whether componentisation is required to present a fair measurement of the depreciation expense and the carrying value of the asset. For this, it is important for companies to engage the plant’s engineering and maintenance personnel or employ outside professionals to devise an appropriate approach for componentisation. Even information technology (IT) personnel may be required to be involved in the componentisation

exercise as IT systems would need to be configured appropriately to handle this additional requirement.

Accordingly, each company would be required to formulate its componentisation policy, keeping reasonable value thresholds in mind, commensurate with the size of the company and industry to which it relates.

Another question which then comes to one's mind is whether a company would need to componentise its assets retrospectively or prospectively i.e., whether the assets existing on the date Schedule II is made effective need to be componentised by applying the transitional provisions of the Schedule or whether the requirement to componentise is applicable only for assets capitalised on or after the effective date of Schedule II.

Schedule II does not provide any exemption for previously capitalised assets from being subjected to componentisation. Companies can use the assets existing in the fixed assets schedule at the date of transition as a start point and based on the nature of the asset / industry and the ability to deduce the components in the past, conduct the exercise of componentisation.

Unless a specific exemption / clarification is provided by the Central Government, the requirement to componentise assets on a retrospective basis may pose practical challenges.

Special plant and machinery

Schedule II introduces the concept of 'Special Plant and Machinery' which classifies assets on the basis of their specified usage. The useful lives for such assets have been determined based on past experience of various industries, which historically have lives which are fairly longer than those prescribed under the general class.

Schedule II identifies numerous assets used for the purposes specified therein. Since Schedule II has used the term "Plant and machinery used in manufacture of …", and not "Plant and machinery used by companies engaged in the manufacture of …..", it is our understanding that if a company owns any asset which is ultimately used in the manufacture of the prescribed products, though the company does not necessarily belong to the specified industry, it may be permitted to apply the useful life prescribed by Schedule II for such assets based on their end use. Accordingly, if a company which is in the business of manufacture of steel has a captive power plant, such a company may also be able to adopt the useful life prescribed for power plants which would normally have been applicable to companies generating, transmitting and distributing power.

Transitional provisions

From the date Schedule II is made effective, the carrying amount of an asset as on that date:

- is required to be depreciated over the remaining useful life of the asset as per the Schedule;
- where the remaining useful life is Nil, is required to be recognised in the opening balance of retained earnings after retaining the residual value.

While Schedule II provides for transitional provisions, AS 6, Depreciation Accounting does not provide for transitional provisions. It therefore appears that the transition provision stated in Schedule II will be available only if, on the date of transition, the Company reduces the previously estimated useful life (whether under Schedule XIV to the 1956 Act or under AS 6) and applies the useful life stated in Schedule II. It appears that the transition provision may not be available / applicable if the useful life of the asset considered on date of transition is different from the useful life stated in Schedule II.

Comparability between companies

This brings us to a debate on the judiciousness of the transitional provisions which may result in significant disparity in the depreciation charge amongst companies operating in the same industry. For example, consider that at the transition date, the remaining useful life for an asset having a written down value of Rs. 600,000 is three years for Company A, one year for Company B and Nil for Company C. As per the transition provisions, Company A would charge Rs. 200,000 to the Statement of Profit and Loss in Years 1 to 3 after transition, Company B would charge Rs. 600,000 to the Statement of Profit and Loss in Year 1 after transition and Company C would adjust the same against the opening balance of retained earnings. This would have a significant impact on the comparability between companies in the initial years.

Negative balance in retained earnings on transition

The carrying amount is to be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil, even if the retained earnings is negative. Accordingly, the effect of such transition should be given to retained earnings only, meaning that the deficit in the Statement of Profit and Loss would increase on such adjustment.

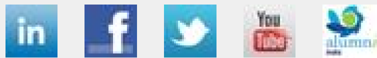
Collateral impact

The consequential effect would be felt on items that are dependent on profits, reserves, etc. including buy back of securities, managerial remuneration, overseas direct investment limits, net worth computations, capital adequacy ratios etc.

Also, since loan covenants are dependent on financial statements and plans / budgets, companies may need to revisit their loan agreements to commence conversations with lenders for any possible amendments.
In case of a public offering, where prior years restated accounts are required to be presented, a question may arise as to whether a change in useful life pursuant to the requirements of Schedule II should be given effect to in the earliest period presented with a consequent re-computation of depreciation for each of the years presented or the change in useful life should be considered as a change in estimate, where retrospective restatement may not be considered necessary. The response to this question may vary. However, if restatement is not done, the comparability of the data for the prior years would surely be vitiated.

Conclusion

As can be seen, the changes stipulated in the 2013 Act pertaining to useful lives of assets and the consequent impact on depreciation will need careful evaluation by companies. The change in the useful lives of assets in many cases, coupled with the transitional provisions and the requirement of componentisation is expected to impact corporate profitability and consequently EPS. For most listed companies which follow the financial year, the impact of this change will necessarily be felt in the first quarter of FY 2014-15 i.e. the quarter ending 30 June 2014. Given the pervasive nature of this change, companies should make an early assessment of the potential impact of the same. By taking a measured and informed approach, companies will be able to identify and establish their policy for depreciating assets, including identification of components of assets to be capitalised and depreciated separately, understand and plan for the financial impact of the changes resulting from the manner in which depreciation is computed and determine appropriate communication to stakeholders. On the other hand, depreciation in the 2013 Act could help companies conserve cash and enable faster growth of capital.



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