DEPRECIATION
(As per Schedule II of the Companies Act, 2013

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Overview

- Definition of Depreciation (As per AS 6)
- Need to charge depreciation
- Methods of depreciation
- Is it to be applied retrospectively or prospectively
- Requirements of Schedule II
- Residual Value
- Transitional Provisions
- Component Accounting
- Continuous Process Plant
- Depreciation on Revalued Assets
- Intangible Assets
- Disclosures

Definition of Depreciation
(Para 3.1 of AS – 6, Depreciation Accounting)

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset.

Depreciation includes amortisation of assets over their useful life.

Why Depreciation should be provided?

Depreciation must be provided in financial statement every year due to:

- Accounting Standards (Section 129 requires accounting standards notified in Sec. 133 to be followed)
- True and Fair View (Section 129)
- Accrual Basis of Accounting (Section 128)
- Declaration of Dividend (Section 123)
- Managerial Remuneration (Section 198)

Depreciation [Schedule II]

The Companies Act, 2013 through Schedule II has brought major change in depreciation.

Schedule II of the Act provides for systematic allocation of **depreciable amount of an asset over its useful life** against the rate based depreciation charged under the Companies Act, 1956.

Depreciation

Companies are divided into two **classes**:

Class I: Companies Other than Class II Companies

Class II: Companies regulated by any other law, i.e., electricity companies, insurance companies

→ Rates/residual values prescribed by regulatory authority

Methods of Depreciation

Depreciation may be charged using:

<u>Either</u>

Useful life of the asset following Written Down Value Method (WDV) or Straight Line Method (SLM)

<u>Or</u>

Unit of Production Method

Depreciation: Prospective or Retrospective

When changed depreciation is to be applied prospectively?

When changed depreciation is to be applied retrospectively?

Schedule II – Useful Lives to Compute Depreciation

Part A

- Depreciation is a systematic allocation of the **depreciable amount** of an asset over its **useful life**.
- Depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value
- Useful life is the period over which an asset is expected to be available for use or the number of production units expected to be obtained from the asset by the entity.
- Useful life of an asset shall **not** ordinarily be different from the useful life specified in Part C.

Schedule II – Useful Lives to Compute Depreciation

Part A

- Where a company uses a useful life <u>different from that specified in Part C</u> or <u>uses residual value different from that specified</u> above justification for the difference shall be disclosed in its financial statement.
- Justification in this behalf should be supported by technical advice.
- For intangible assets, the provision of accounting standards applicable for the time being in force shall apply except for toll roads for which method is prescribed in the Schedule.

Schedule II – Useful Lives to Compute Depreciation

Part B

Useful life and residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirement of this Schedule.

(Applicable to Class II Companies)

Schedule II – Useful Lives to Compute Depreciation

Part C

- Details nature of asset and their useful life
- No Extra-shift depreciation on certain assets.
- For Double-shift - 50% more number of days worked
- For Triple-shift – 100% more number of days worked

Schedule II – Useful Lives to Compute Depreciation

- Paragraph 4 of Notes is as follows:

  Useful life specified in Part C of the schedule is for the whole of the asset and where cost of a part of the asset is significant 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.

- Requirement is voluntary for Financial Year 2014-15 but mandatory thereafter.

Schedule II – Useful Lives to Compute Depreciation

Part C

- From the date this schedule comes into effect, the carrying amount of asset on that date:
  - shall be depreciated over the remaining useful life of the asset as per this schedule.
  - after retaining the residual value, may be recognised in the opening balance of retained earning or may be charged to Profit and Loss Account where the remaining useful life of an asset is nil.

Residual Value

Residual value of an asset shall **not be more** than 5% of the original cost

(**Revised vide Notification dated 29.8.2014**)

Transitional Provisions of Schedule II

Remaining useful life of asset as per Companies Act, 2013 as on April 1, 2014

Life Remains

Shall be depreciated over the remaining useful life of the asset

Debit to Profit and Loss Account

Remaining Life Nil

Determine Net Carrying amount after Retaining Residual Value

Debit Either Opening Retained Earnings (Surplus) or Profit and Loss Account

Schedule II – Useful Lives to Compute Depreciation /Accounting Standard - 6

CASES : USEFUL LIFE	RESPONSE
Management Estimates Useful Life (AS- 6) : 10 Years Useful Life given in Schedule II: 12 Years	AS- 6 requires the company to depreciate the asset using 10 years useful life only. Schedule II requires disclosure of justification for using lower life. The company cannot use 12 year life for depreciation.
Management Estimates Useful Life (AS-6) : 12 Years Useful Life given in Schedule II: 10 Years	In this case, company has an option to depreciate the asset using either 10 year life as prescribed in the Schedule II or use estimated useful life i.e., 12 years. If company depreciate the asset in 12 years, justification is required.

Schedule II – Useful Lives to Compute Depreciation /Accounting Standard - 6

CASES: RESIDUAL VALUE	RESPONSE
Management Estimates Residual Value as per AS-6 : Nil Residual Value as per Schedule II not to be more than 5% of the cost	The company cannot use 5% residual value. In addition, Schedule II requires disclosure of justification only in case of residual value **exceeds** 5% of the cost.
Management Estimates Residual Value as per AS-6 : 10% of the cost Residual Value as per Schedule II not to be more than 5% of the cost	In this case, if the company depreciates the asset using 10% estimated residual value, it needs to disclose justification for using the higher residual value.

COMPONENT ACCOUNTING

- Companies will need to identify and depreciate significant components with different useful life separately.
- Component accounting is required to be implemented for the entire block of assets. It is not to be restricted to new assets acquired.
- Optional for FY beginning April 1, 2014 and mandatory for FY beginning April 1, 2015.

COMPONENT ACCOUNTING

- 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:

  (i) Significant Cost, and

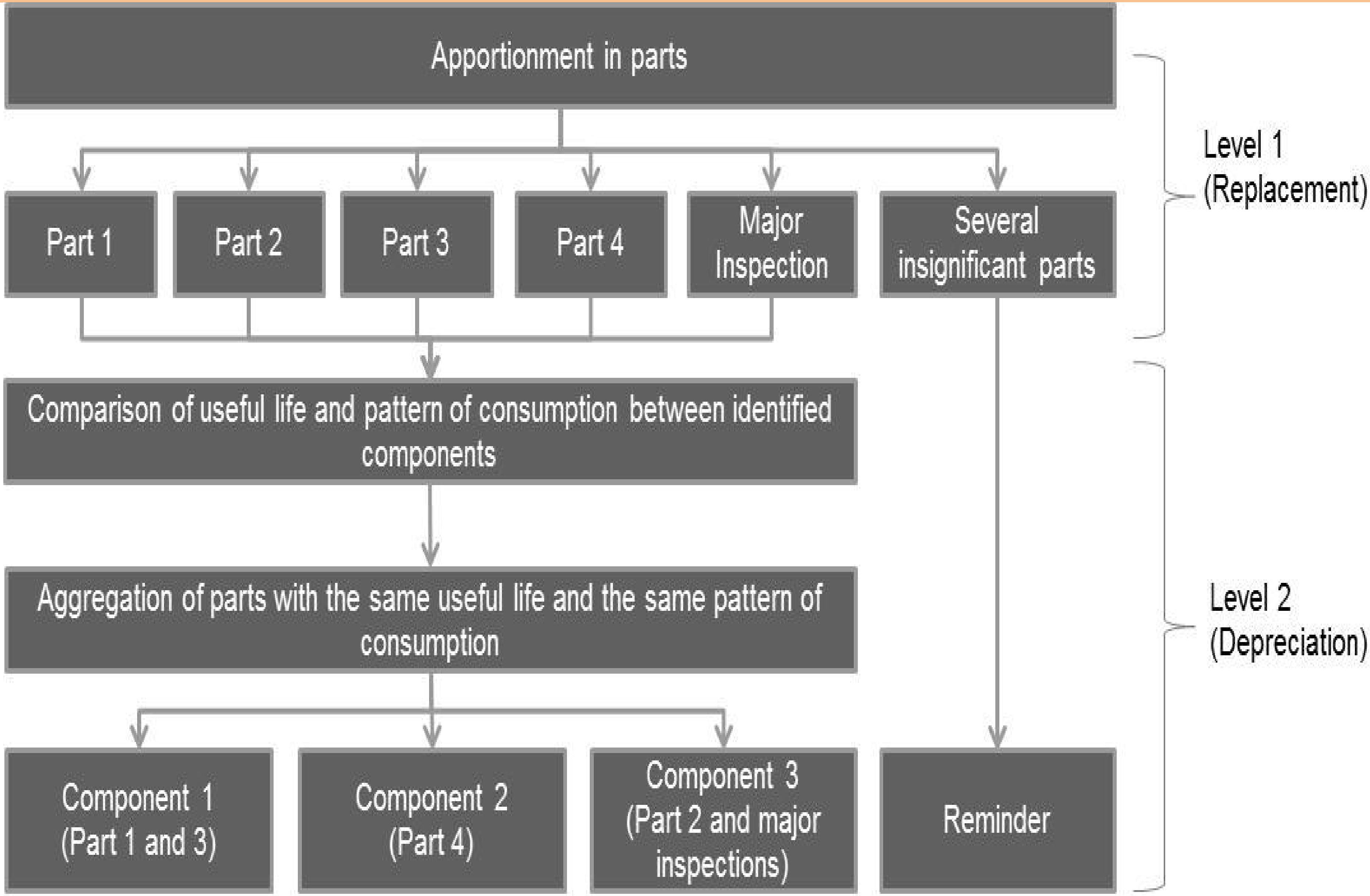
  (ii) Different useful lives from remaining parts of the asset.

- A company needs to identify material/ significant components separately for depreciation. Materiality is a matter of judgment and needs to be decided on the facts of each case.

COMPONENT ACCOUNTING

- 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 life should be used.
- 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.

COMPONENT ACCOUNTING



Schedule II – CONTINUOUS PROCESS PLANT

- Continuous process plant' means a plant which is required and designed to operate 24 hours a day.
- The words "required and designed to operate 24 hours a day" are significant and should be interpreted with reference to the inherent technical nature of the plant, i.e., the technical design of a continuous process plant is such that there is a requirement to run it continuously for 24 hours a day.
- It is, however, possible that due to various reasons, e.g., lack of demand, maintenance etc., and such a plant may be shut down for some time. The shutdown does not change the inherent technical nature of the plant.

Depreciation in case of Revaluation of Assets

- Schedule II of Companies Act, 2013 Act requires depreciation to be provided on historical cost or the amount substituted for the historical cost.
- In case of revaluation, a company needs to charge depreciation based on the revalued amount.
- AS 10 allows amount standing to the credit of revaluation reserve to be transferred directly to the general reserve on retirement or disposal of revalued asset.
- A company may transfer the whole of the reserve when the asset is sold or disposed of.

Action Points to implement Schedule II

- Determine date of purchase of the asset.
- Determine the cost of asset debited.
- Determine total amount of depreciation charged up to 31st March, 2014 of the asset.
- Determine Useful Life of the asset **or** take Useful Life as given in Schedule II of the Act.
- If Useful Life is different from that given in Schedule II of the Act, give reason supported by technical report.

Action Points to implement Schedule II

- Determine residual value of the asset.
- Determine the amount to be written off over the remaining Useful Life.

  It is Cost less depreciation charged on the asset up to 31st March, 2014.
- Determine the Rate of Depreciation to write off the balance amount over the remaining Useful Life.

WDV METHOD

If a company uses Written Down Value (WDV) method of depreciation, it will need to calculate new rate for depreciation to depreciate the asset over their remaining useful life using the formula for calculation of rate for depreciation as per WDV method which is reproduced below –

$$\mathbf{R = \{1 - (s/c)^{1/n}\} \times 100}$$

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

Note : It may be noted that upon transition to Schedule II, the company may have different rates of depreciation for individual assets within the same class in case of existing assets as there will be a different remaining useful life for each asset.

Comparative Rates – Factory Building

Schedule II	Schedule XIV
• Useful life - 30 Years • SLM Rate – 3.17% • WDV Rate - 9.5 %	• WDV Rate - 10% • SLM Rate - 3.34% • Useful life - 23 years

Comparative Rates – Temporary Structure

Schedule II	Schedule XIV
• Useful life - 3 Years • SLM rate - 31.67% • WDV rate - 63 %	• SLM rate - 100% • WDV rate - 100% • Useful life - 0 year

Comparative Rates – P & M (General Rate)

Schedule II	Schedule XIV
• Useful Life - 15 Years • SLM Rate - 6.33% • WDV Rate - 18.10%	• SLM Rate - 4.75% • WDV Rate - 13.91% • Useful Life - 20 years

Comparative Rates – P & M (Continuous Process)

Schedule II	Schedule XIV
• Useful Life - 25 Years • SLM Rate - 3.80% • WDV Rate - 11.29%	• SLM Rate - 5.28% • WDV Rate - 15.33% • Useful Life - 18 years

Comparative Rates – Furniture & Fixtures

Schedule II	Schedule XIV
• Useful Life - 10 Years • SLM Rate - 9.5% • WDV Rate - 25.89%	• SLM Rate - 6.33% • WDV Rate - 18.10% • Useful Life - 15 years

Revision of Depreciation Rates :

EXAMPLE: 1 (SLM METHOD)	
Useful Life of Machinery (Sch. XIV)	20 Yrs.
Useful Life of Machinery (Under Sch. II)	15 Yrs.
Cost of Machinery (installed on 1.4.2009)	Rs. 5,00,000
Depreciation Rate Under Sch. XIV- SLM	4.75%
Depreciation Per year	**Rs. 23,750**
WDV as on 1.4.2014	Rs.3,81,250
Remaining Useful Life Sch. II on 1.4.2014	10 Yrs.
Dep. Rate for remaining Useful Life –SLM	7.125%
Depreciation Per year	Rs. 35,625

Revision of Depreciation Rates :

EXAMPLE 1A : WDV METHOD	
Useful Life of Machinery (Sch. XIV)	20 Yrs.
Useful Life of Machinery (Under Sch. II)	15 Yrs.
Cost of Machinery (installed on 1.4.2009)	Rs. 5,00,000
Residual Value (5 % of Rs. 5,00,000)	25,000
Depreciation Rate Under Sch. XIV- WDV	13.91%
Depreciation till the yr ended March 31, 2014	**Rs. 3,88,186**
WDV as on 1.4.2014	Rs.1,11,814
Remaining Useful Life Sch. II on 1.4.2014	10 Yrs.
Dep. Rate for remaining Useful Life	13.92%
Depreciation Per year	Rs. 15,560

Revision of Depreciation Rates

EXAMPLE 2 : SLM METHOD	
Useful life of Machinery (Sch. XIV)	20 Yrs.
Useful life of Machinery (under Sch. II)	15 Yrs.
Cost of Machinery (installed on 1.4.2000)	Rs. 5,00,000
Depreciation Rate under Sch. XIV- SLM	4.75%
Depreciation Per Year	**Rs. 23,750**
WDV as on 1.4.2014	Rs.1,67,500
Remaining Useful Life Sch. II on 1.4.2014	1 Yr.
Dep. rate for remaining useful life –SLM	100%
Residual Value (2% of Rs. 5,00,000)	Rs. 10,000
Depreciation (Rs. 1,67,500 – Rs. 10,000)	Rs. 1,57,500

Revision of Depreciation Rates

EXAMPLE 2A : WDV METHOD	
Useful life of Machinery (Sch. XIV)	20 Yrs.
Useful life of Machinery (under Sch. II)	15 Yrs.
Cost of Machinery (installed on 1.4.2000)	Rs. 5,00,000
Depreciation Rate under Sch. XIV- SLM	13.91%
Depreciation till the year ended March 31, 2014	**Rs. 4,38,580**
WDV as on 1.4.2014	Rs.61,420
Remaining Useful Life Sch. II on 1.4.2014	1 Yr.
Dep. rate for remaining useful life – WDV	8.30%
Residual Value (2% of Rs. 5,00,000)	Rs. 10,000
Depreciation	Rs. 51,420

Effect of Change in Useful Life

EXAMPLE 3 : SLM METHOD

Useful life of Machinery (Sch. XIV)	20 Yrs.
Useful life of Machinery (under Sch. II)	15 Yrs.
Cost of Machinery (installed on 1.4.1996)	Rs. 5,00,000
Depreciation Rate under Sch. XIV- SLM	4.75%
Depreciation Per Year	**Rs. 23,750**
WDV as on 1.4.2014	Rs. 72,500
Remaining Useful Life Sch. II on 1.4.2014	Nil
Residual Value	25,000
Amount to be debited to Opening Balance of Surplus Account or Profit and Loss Account (Rs. 72,500- Rs. 25000)	Rs. 47,500

Effect of Change in Useful Life

EXAMPLE 3A : WDV METHOD

Useful life of Machinery (Sch. XIV)	20 Yrs.
Useful life of Machinery (under Sch. II)	15 Yrs.
Cost of Machinery (installed on 1.4.1996)	Rs. 5,00,000
Depreciation Rate under Sch. XIV- SLM	13.91%
Depreciation till the yr ended March 31, 2014	**Rs. 4,66,262**
WDV as on 1.4.2014	Rs. 33,738
Remaining Useful Life Sch. II on 1.4.2014	Nil
Residual Value	Rs. 25,000
Amount to be debited to Opening Balance of Surplus Account/ Profit and Loss Account	Rs. 8,738

Case Studies

SLM Method: Original Cost of Asset : Rs. 1,00,000

Residual Value: Rs. 5,000, Depreciation Rate: 6.33%

Useful Life as per Schedule II: 10 Years

Case	Year of Purc-hase	No. Of year used till 31.03.2014	Depreciati on till 31.03.2014	WDV on 31.03. 2014	Accounting Treatment
1	2003-04	10	63,300	36,700	Useful Life is Nil, Rs. 31,700/- (Rs. 36,700-Rs.5,000) will be charged to Opening Retained Earnings or Profit & Loss Account.
2	2004-05	9	56,970	43,030	Since 1 year is an amount of Rs. Rs. 38,030(Rs. 43,030 – Rs. 5,000) will be debited to P&L as depreciation.
3	2005-06	8	50,640	49,340	Since 2 years are left so depreciation charged shall be 22,180 {(Rs. 49,360 -5000)/2} in next two year.

Case Studies

SLM Method: Original Cost of Asset : Rs. 1,00,000

Residual Value: Rs. 5,000, Depreciation Rate : 15%

Case	Year of Purchase	No. Of year used till 31.03.2014	Depreciation till 31.03.2014	WDV on 31.03. 2014	Accounting Treatment
4	2008-09	6	90,000	10,000	Useful Life is Nil, Rs. 5,000/- (Rs. 10,000-Rs.5,000) will be charged to Opening Retained Earnings or Profit & Loss Account.
5	1st Oct. 2007	6.5	97,500	2,500	Useful Life is Nil, Rs. 2,500 as residual value will be charged to Opening Retained Earnings or Profit & Loss Account. In such case, the company can not charged depreciation during the year. An assets stands Rs. 2,500 in books of account till date the sale or discarded.

AS – 26, Intangible Assets

For intangible assets, the provisions of the accounting standards applicable for the time being in force shall apply, except in case of intangible assets (Toll Roads) created under ‘Build, Operate and Transfer’, ‘Build, Own, Operate and Transfer’ or any other form of public private partnership route in case of road projects.

Intangible Assets

- 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
- It 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

Disclosures

- Is it change in Accounting Policies
- Impact of change on profit / loss for the year due to change in Notes to Accounts

Change in Accounting Policy

Depreciation, Amortisation and Impairment

Depreciation on all assets of the Company is charged on straight line method over the useful life of assets mentioned in Schedule II to the Companies Act ,2013 or the useful life previously assesed by the management based on technical review whichever is lower for the proportionate period of use during the year. Intangible assets are amortised over the economic useful life estimated by the management.

Change in Accounting Policy

Depreciation on assets costing less than Rs 5,000/-

Till year ended 31 March 2014, to comply with the requirements of Schedule XIV to the Companies Act, 1956, the company was charging 100% depreciation on assets costing less than Rs 5,000/- in the year of purchase. However, Schedule II to the Companies Act 2013, applicable from the current year, does not recognize such practice. Hence, to comply with the requirement of Schedule II to the Companies Act, 2013, the company has changed its accounting policy for depreciations of assets costing less than Rs 5,000/-.

Disclosure: Change in Estimate

The company has adopted Schedule II to the Companies Act, 2013, for depreciation purposes, from 1 April 2014 as against Schedule XIV of the Companies Act, 1956.

Due to application of Schedule II of the Companies Act, 2013, the company has changed the manner of depreciation for its fixed assets. The company has used transitional provisions of Schedule II to adjust the impact arising on its first application. If an assets has ‘nil’ remaining useful life on 1st April, 2014, its carrying amount, after retaining any residual value, is charged to the opening balance of retained earnings.

Disclosure: Change in Estimate

Had the company continued to use the earlier policy of depreciating fixed asset, the profit for the current period would have been higher by Rs. XXX, retained earnings at the beginning of the current period would have been higher by Rs. XXX (net of tax impact of Rs. XXX) and the fixed asset would correspondingly have been higher by Rs. XXX.

Disclosure (Component Accounting)

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.

Disclosure (Component Accounting)

If a component has zero remaining useful life on the date of Schedule II becoming effective, i.e., 1st April 2014, 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 1st April 2014, 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 Rs. XXX (net of tax impact of Rs. XXX), retained earnings at the beginning of the current period would have been higher by INR XXX (net of tax impact of Rs. XXX) and the fixed asset would correspondingly have been higher by Rs. XXX.

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