## Depreciation of fixed assets

### What the Companies Act 2013 states

#### Amendments in Schedule II to the 2013 Act

### Minimum vs. indicative rates

In Schedule II originally notified, all companies were divided into three classes.

- Class I basically included companies which may eventually apply Ind-AS. These companies were permitted to adopt a useful life or residual value, other than those prescribed under the schedule, for their assets, provided they disclose justification for the same.
- Class II covered companies or assets where useful lives or residual value are prescribed by a regulatory authority constituted under an act of the Parliament or by the Central Government. These companies will use depreciation rates/useful lives and residual values prescribed by the relevant authority.
- Class III covered all other companies. For these companies, the useful life of an asset will not be longer than the useful life and the residual value will not be higher than that prescribed in Schedule II.

Pursuant to a recent amendment to Schedule II, distinction between class (i) and class (iii) has been removed. Rather, the provision now reads as under:

- “(i) 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. Such disclosure will form part of the financial statements.

### EY insights

Proviso in the latest amendment to Schedule II states that if a company uses a useful life or residual value of the asset which is different from limit given in the Schedule II, justification for the difference is disclosed in its financial statements. How is this proviso applied if notified accounting standards, particularly, AS 6 is also to be complied with?

AS 6 states that depreciation rates prescribed under the statute are minimum. If management’s estimate of the useful life of an asset is shorter than that envisaged under the statute, depreciation is computed by applying the higher rate. The interaction of the above proviso and AS 6 is explained with simple 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.
- 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.
- Similar position will apply for the residual value. The management has estimated that AS 6 life of an asset and life envisaged in the Schedule II is 10 years. The estimated AS 6 residual value of the asset is nil. The residual value envisaged under the Schedule II is 5%. In this case, AS 6 depreciation is the minimum threshold. The company cannot use 5% residual value. In addition, Schedule II requires disclosure of justification for using a lower residual value.
- Alternatively, let us assume that the management has estimated AS 6 residual...
Continuous process plan

Under Schedule II as originally notified, useful life of the CPP, for which there is no special depreciation rate otherwise prescribed, was 8 years. This was a major concern for certain companies using CPP as they would have been required to write-off their entire plant over 8 years. The amendment to Schedule II has resolved the issue as useful life of the CPP has now been increased to 25 years. Moreover, the impact of amendment as explained in the preceding paragraph is that a company can depreciate its CPP over a period shorter or longer than 25 years, with proper justification.

BOT assets

In accordance with amendment made to Schedule XIV to the 1956 Act in April 2012, a company was allowed to use revenue based amortization for intangible assets (toll roads) created under BOT, BOOT or any other form of PPP route (collectively, referred to as “BOT assets”). Since Schedule II as originally notified did not contain a similar provision, an issue had arisen whether revenue based amortization will be allowed going forward.

The recent amendment to Schedule II has addressed this concern. In accordance with the amendment, a company may use revenue based amortization for BOT assets. For amortization of other intangible assets, AS 26 needs to be applied.

Double/ triple shift working

Under Schedule II, no separate rates/ lives are prescribed for extra shift working. Rather, it states that for the period of time, an asset is used in double shift depreciation will increase by 50% and by 100% in case of triple shift working.

Let us assume that a company has purchased one plant and machinery three years prior to the commencement of the 2013 Act. Under Schedule XIV, single, double and triple shift depreciation rates applicable to the asset are 4.75%, 7.42% and 10.34%, respectively. Under Schedule II, its life is 15 years. For all three years, the company has used the asset on a triple shift basis and therefore, depreciated 31.02% of its cost over three years. For simplicity, residual value is ignored.

Whether the amendment regarding BOT assets allows revenue based amortization only for toll roads? Or can a company apply revenue based amortization to other type of intangible assets created under the BOT model?

The amendment in Schedule II reads as follows “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 BOT, BOOT or any other form of public private partnership route in case of road projects.” The amendment clearly suggests that revenue based amortization applies to toll roads. The same method cannot be used for other intangible assets even if they are created under PPP schemes, such as airport infrastructure.

Schedule II clarifies that the useful life is given for whole of the asset. If the 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 will be determined separately. This implies that component accounting is mandatory under Schedule II. How does component accounting interact with AS 6 requirements and the amendment in the Schedule II, which allows higher or lower useful life, subject to appropriate justification being provided?

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.

The application of component accounting, including
On transition to Schedule II, the asset has remaining Schedule II life of 12 years, i.e., 15 years – 3 years. The management has estimated that on single shift basis, remaining AS 6 life is also 12 years. The company will depreciate carrying amount of the asset over 12 years on a straight-line basis. If the company uses the asset on triple shift basis during any subsequent year, depreciation so computed will be increased by 100%. In case of double shift, depreciation will be increased by 50%.

Transitional provisions

With regard to the adjustment of impact arising on the first-time application, the transitional provisions to Schedule II state as below:

“From the date Schedule II comes into effect, the carrying amount of the asset as on that date:

- Will be depreciated over the remaining useful life of the asset as per this Schedule,
- After retaining the residual value, will be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil.”

Is component accounting required to be done retrospectively or prospectively?

Component accounting is required to be done for the entire block of assets as at 1 April 2014. It cannot be restricted to only new assets acquired after 1 April 2014.

How do transitional provisions in Schedule II apply to component accounting?

AS 10 gives companies an option to follow the component accounting; it does not mandate the same. In contrast, component accounting is mandatory under the Schedule II. Considering this, we believe that the transitional provisions of Schedule II can be used to adjust the impact of component accounting. If a component has zero remaining useful life on the date of Schedule II becoming effective, i.e., 1 April 2014, its carrying amount, after retaining any residual value, will be 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 1 April 2014, is depreciated over their remaining useful life. The transitional provisions relating to the principal asset minus the components are discussed elsewhere in this publication.

In case of revaluation of fixed assets, companies are currently allowed to transfer an amount equivalent to the additional depreciation on account of the upward revaluation of fixed assets from the revaluation reserve to P&L. Hence, any upward revaluation of fixed assets does not impact P&L. Will the same position continue...
under the 2013 Act also? If not, how can a company utilize revaluation reserve going forward?

Under the 1956 Act, depreciation was to be provided on the original cost of an asset. Considering this, the ICAI Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets allowed an amount equivalent to the additional depreciation on account of the upward revaluation of fixed assets to be transferred from the revaluation reserve to the P&L.

In contrast, Schedule II to the 2013 Act requires depreciation to be provided on historical cost or the amount substituted for the historical cost. In Schedule II as originally notified, this requirement was contained at two places, viz., Part A and notes in Part C. Pursuant to recent amendment in Schedule II, the concerned note from part C has been deleted. However, there is no change in Part A and it still requires depreciation to be provided on historical cost or the amount substituted for the historical cost. Therefore, in case of revaluation, a company needs to charge depreciation based on the revalued amount. Consequently, the ICAI Guidance Note, which allows an amount equivalent to the additional depreciation on account of upward revaluation to be recouped from the revaluation reserve, may not apply. Charging full depreciation based on the revalued amount is expected to have significant negative impact on the P&L.

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. Alternatively, it may transfer proportionate amount as the asset is depreciated.

Schedule II to the 2013 Act is applicable from 1 April 2014. Related rules, if any, also apply from the same date. It may be noted that the requirements of Schedule II are relevant not only for preparing financial statements, but also for purposes such as declaration of dividend. Given this background, is Schedule II applicable to financial years beginning on or after 1 April 2014 or it also needs to be applied to financial statements for earlier periods if they are authorized for issuance post 1 April 2014?

Schedule II is applicable from 1 April 2014. As already mentioned, Schedule II contains depreciation rates in the context of Section 123 dealing with “Declaration and payment of dividend” and companies use the
same rate for the preparation of financial statements as well. Section 123, which is effective from 1 April 2014, among other matters, states that a company cannot declare dividend for any financial year except out of (i) profit for the year arrived at after providing for depreciation in accordance with Schedule II, or (ii) …

Considering the above, one view is that for declaring any dividend after 1 April 2014, a company needs to determine profit in accordance with Section 123. This is irrespective of the financial year-end of a company. Hence, a company uses Schedule II principles and rates for charging depreciation in all financial statements finalized on or after 1 April 2014, even if these financial statements relate to earlier periods.

The second view is that based on the General Circular 8/2014, depreciation rates and principles prescribed in Schedule II are relevant only for the financial years commencing on or after 1 April 2014. The language used in the General Circular 8/2014, including reference to depreciation rates in its first paragraph, seems to suggest that second view should be applied. For financial years beginning prior to 1 April 2014, depreciation rates prescribed under the Schedule XIV to the 1956 Act will continue to be used.

In our view, second view is the preferred approach for charging depreciation in the financial statements. For dividend declaration related issues, reference is drawn to discussion under the section “Declaration and payment of dividend.”

How do the transitional provisions apply in different situations? In situation 1, earlier Schedule XIV and now Schedule II provide a useful life, which is much higher than AS 6 useful life. In situation 2, earlier Schedule XIV and now Schedule II provide a useful life, which is much shorter than AS 6 useful life.

In situation 1, the company follows AS 6 useful life under the 1956 as well as the 2013 Act. In other words, status quo is maintained and there is no change in depreciation. Hence, the transitional provisions become irrelevant. In situation 2, when the company changes from Schedule XIV to Schedule II useful life, the transitional provisions would apply. For example, let’s assume the useful life of an asset under Schedule XIV, Schedule II and AS 6 is 12, 8 and 16 years respectively. The company changes the useful life from 12 to 8 years and the asset has already completed 8 years of useful life, i.e., its remaining useful life on the transition date is nil. In this case, the transitional provisions would apply and
the company will adjust the carrying amount of the asset as on that date, after retaining residual value, in the opening balance of retained earnings. If on the other hand, the company changes the useful life from 12 years to 16 years, the company will depreciate the carrying amount of the asset as on 1 April 2014 prospectively over the remaining useful life of the asset. This treatment is required both under the transitional provisions to Schedule II and AS 6.

Let us assume that a company has adjusted WDV of an asset to retained earnings in accordance with the transitional provisions given in Schedule II? Should such adjustment be net of related tax benefit?

Attention is invited to the ICAI announcement titled, “Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account.” The Announcement, among other matters, states as below:

- “… Any expense charged directly to reserves and/or Securities Premium Account should be net of tax benefits expected to arise from the admissibility of such expenses for tax purposes. Similarly, any income credited directly to a reserve account or a similar account should be net of its tax effect.”

Considering the above, it seems clear that amount adjusted to reserves should be net of tax benefit, if any.