Application Guide on Provisions of Depreciation as per Companies Act, 2013

The Institute of Chartered Accountants of India (ICAI) has issued Application Guide (hereafter referred as 'the Guide') to provide guidance on implementation of the provisions of the Schedule II of Companies Act, 2013 which is in respect of Depreciation norms applicable for the financial year commencing on or after 1st April, 2014 unless mentioned otherwise.

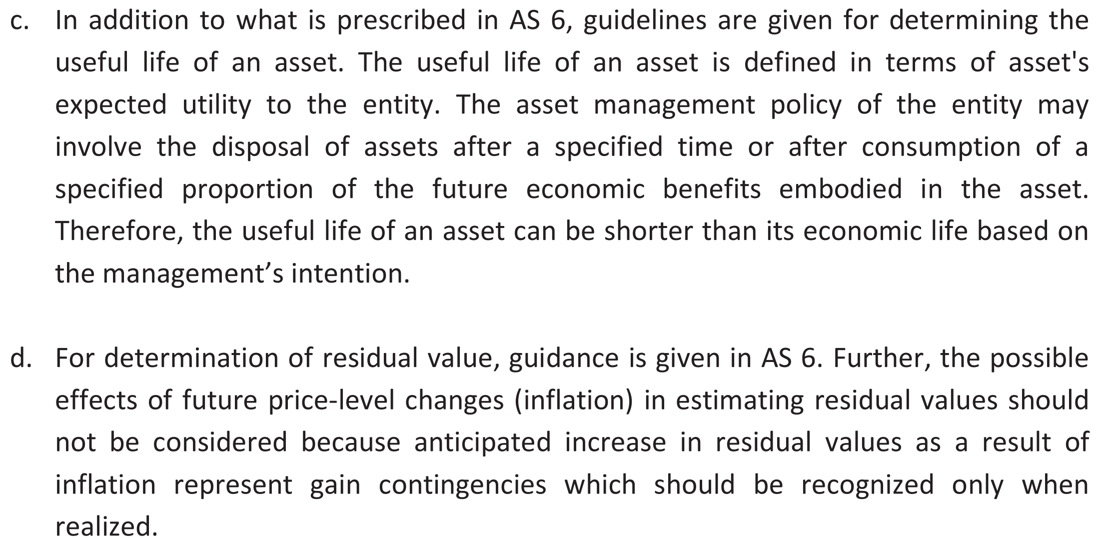
The guide covers clarifications in relation to assessment of useful life/residual value, depreciation for intangible assets, component accounting, double/triple shift working, transitional provisions and depreciation in case of revaluation of assets. Also examples are given for easy understanding of the provisions of Schedule II (refer para 7 below).

The key guidance provided are summarized below:

1) Assessment of useful life and residual value

a. In accordance with the Schedule II, if the company uses a different useful life or a residual value of more than 5%, disclosure in the financial statements is required for the difference along with justification duly supported by the technical advice. Hence, determination of useful life/residual value is a matter of judgement and may be decided on a case to case basis. It is not merely an accounting exercise; rather, it involves technical expertise. Hence, the companies will have to necessarily involve technical experts to determine the useful life of the asset.
   However, it is not clarified in the guide whether the technical expert can be in-house or has to be external.

b. In case management has estimated useful life as per AS 6 'Depreciation Accounting' which is lower than useful life specified under Schedule II, then management cannot consider useful life as per Schedule II. However, where estimated useful life as per AS 6 is more as compared to Schedule II, the company will have an option to use either of the two. This would also apply for estimated residual value. Accordingly, if the companies had estimated shorter useful life in earlier years as per AS 6 (as compared to Schedule XIV), they are required to continue with the same and should not change to useful life given as per Schedule II in respect of such assets at the time of transition. Disclosure as regards the difference along with technical justification will have to be made in financials.



c. In addition to what is prescribed in AS 6, guidelines are given for determining the useful life of an asset. The useful life of an asset is defined in terms of asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset can be shorter than its economic life based on the management's intention.

d. For determination of residual value, guidance is given in AS 6. Further, the possible effects of future price-level changes (inflation) in estimating residual values should not be considered because anticipated increase in residual values as a result of inflation represent gain contingencies which should be recognized only when realized.

2) Component accounting

a. Component accounting is required to be done for the entire block of assets as on 1st April, 2014 if a company opts to adopt it voluntarily and as at 1st April, 2015 mandatorily. It cannot be restricted to only new assets acquired after 1st April, 2014 or 1st April, 2015 as the case may be.

b. Though the principle of component accounting was already allowed under AS 10; there seemed to be a choice in its implementation. However, Schedule II requires application of component accounting mandatorily when relevant and material.

c. Detailed guidelines are given for assessment and identification of the significant component. These includes:
   i. Comparison of cost allocated to the item out of total cost of the block of assets.
   ii. Consideration of potential impact of componentization on depreciation expense.

d. Identification of separate parts of an asset and determination of their useful life is not merely an accounting exercise; hence, it may be necessary to involve technical experts to determine the parts of an asset having different useful life.

e. At the time of implementation, it is possible that separate cost of each significant component of an asset is not available in books of account. In such case, following criterias can be used for determining the cost of such significant component:
   i. Break up of cost provided by the vendor.
   ii. Cost break up given by internal/external technical expert.
   iii. Current replacement cost of component of the related asset and applying the same ratio on the historical cost of asset.

f. The company must split the fixed asset into various separate 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:
   (i) Structural design
   (ii) Elevators
   (iii) Heating system
   (iv) Water system
   (v) Electrical system

g. In determining materiality, Company may adopt criteria of percentage of gross block. Additionally, factors like impact on retained earnings, current year profit/loss, future profit/loss (when part will be replaced) also need to be considered to decide materiality. If a component may have material impact from either perspective, the said component will be material and require separate identification.

h. 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. In vice versa case, 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.

3) Double/ triple shift working

For determining depreciation charge for assets used in double/triple shift operations, the useful life as given in Schedule II is to be treated as based on single shift operations. When an asset is used for double/triple shift operations, the useful life of the asset will not change. As provided in Schedule II, the depreciation charge will increase by 50% or 100% for double/triple shift operations, as the case may be. Example is given in the guide for assessment of useful life for asset purchased prior to commencement of Companies Act, 2013 and which has been used on triple shift basis in earlier years. Accordingly, useful life as per Schedule XIV of the Companies Act 1956 is to be considered on single shift basis to identify remaining useful life for the purpose of calculation of depreciation under Schedule II. 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%.

4) Depreciation in case of revaluation of assets

Schedule II 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 to the Statement of Profit and Loss may not apply. The company may still transfer the equivalent amount of depreciation charge on revalued portion from Revaluation reserve to surplus in the Statement of Profit and Loss.

5) Continuous process plant

Companies can continue to follow the guidance note issued by the ICAI with regard to continuous process plant – "Guidance note on some important issues arising from the amendments to Schedule XIV to the Companies Act, 1956."

'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 very 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. If it is not so run, there are significant shut-down and/or start-up costs.

The shutdown does not change the inherent technical nature of the plant. For instance, a blast furnace which is required and designed to operate 24 hours a day, may be shut down due to various reasons; it would still be considered as a continuous process plant.

A continuous process plant is distinct from the repetitive process plant or assembly-line type plants. These plants are not continuous process plants since such plants do not involve significant shut-down and/or start-up costs and are not technically required and designed to operate 24 hours a day, e.g., an automobile manufacturing plant.

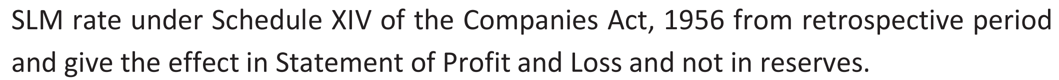
Requirements of component accounting will apply to continuous process plants also.

6) Transitional provision

If the Company opts to adjust the carrying amount of the assets to the retained earnings in accordance with the transitional provisions of the Schedule II, the tax effect of the same has to be also adjusted directly against the retained earnings in accordance with the ICAI announcement.

7) Summary based on the some of the examples given in guide

a. In case the company was following WDV method under Schedule XIV of the Companies Act, 1956 and consequent upon transition to Schedule II it does not use WDV method and uses Straight Line Method (SLM), then it will be considered as change in accounting policy as per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' and transitional provision under Schedule II will not apply. Accordingly the company has to re-compute the depreciation as per



SLM rate under Schedule XIV of the Companies Act, 1956 from retrospective period and give the effect in Statement of Profit and Loss and not in reserves.

b. Company may have a policy to fully depreciate assets upto certain threshold limits considering materiality aspect in the year of acquisition.

c. In respect of the financial year for the year ending 31st December, 2014, requirements of the Schedule XIV of the Companies Act, 1956 will be applicable and Schedule II will be applicable for year ending 31st December, 2015.

Guide is available on http://220.227.161.86/37329clcgc27675.pdf

In case of any clarification, you may reach us at **nashah@nashah.com**

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