

Depreciation under New Companies Bill

Schedule XIV of the Companies Act prescribes SLM (straight line method) and WDV (written down value) rates for depreciation. In accordance with AS-6 Depreciation Accounting, the rates prescribed under Schedule XIV are minimum. If the useful life of an asset is shorter than that envisaged under Schedule XIV, depreciation should be higher.

Under the Companies Bill, Schedule XIV is replaced by Schedule II, which divides companies into three classes. Class-1 will comprise the prescribed class (essentially those following Ind-AS). These companies can adopt a useful life or residual value for assets that is different from Schedule II values, provided they disclose the justification.

Class-2 is companies constituted under an Act of Parliament or by the Central Government, such as electricity companies. The useful lives and residual values will be prescribed by the relevant authority. Class-3 will comprise all other companies, for which the useful life and residual value will not exceed Schedule II values.

It is not clear when class-1 companies will be prescribed. If prescribed after Ind-AS is implemented, then they will fall in class-3 by default when the Bill becomes legislation. In other words, future class-1 companies will have to follow Schedule II in the meanwhile.

Overall, many companies may need to charge higher depreciation in the profit-and-loss account owing to pruning of useful lives as compared to earlier rates. The useful life has decreased for general plant and machinery from 20 to 15 years, general furniture from 15 to 10 years, continuous process plant from 18 to eight years, laptops from six to three years, and so on.

However, in some cases it can also result in lower depreciation — that is, when the useful lives are much longer than earlier rates, as in the case of metal pot line, bauxite crushing and grinding section used in the manufacture of non-ferrous metals.

The transitional provision, which requires depreciating the remaining carrying value over the remaining useful life (as determined under Schedule II), can provide harsh outcomes. For example, suppose the remaining carrying value is 60 per cent of the original cost, while the remaining useful life under Schedule II is one year. Here, the entire 60 per cent will be depreciated in one year. However, if the remaining useful life was nil, the entire 60 per cent would be charged to retained earnings.

Schedule XIV was recently amended to allow BOT (build-operate-transfer) assets to be amortised according to revenue pattern. Under the Bill, all intangible assets should be amortised according to the notified accounting standard.

In the context of the International Financial Reporting Standards (IFRS), the IFRS Interpretations Committee (IFRIC) and the International Accounting Standards Board (IASB) have already concluded that revenue-based amortisation is not appropriate because it reflects a pattern of future economic benefits generated from the asset, rather than a pattern of the consumption of the future economic benefits embodied in the asset.

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However, there is no such clarification in the context of the notified AS. Consequently, it seems unclear at this stage whether infrastructure companies can use revenue-based amortisation under AS-26 after the enactment of the Companies Bill.

Schedule XIV requires depreciation based on historical cost. Accordingly, the CA Institute's guidance note on 'Treatment of Reserve Created on Revaluation of Fixed Assets' allows transferring from the revaluation reserve to the profit-and-loss statement an amount equivalent to the additional depreciation resulting from the upward revaluation of fixed assets. Under the Bill, depreciation is based on cost or any amount substituted for cost. Thus, depreciation will be based on the re-valued amount, and the incremental depreciation cannot be recouped from the revaluation reserve.

Under Schedule XIV, assets whose actual cost does not exceed Rs 5,000 are depreciated at 100 per cent. Under Schedule II, there is no requirement to charge 100 per cent depreciation on assets whose actual cost does not exceed Rs 5,000. These assets will be depreciated in accordance with their useful lives.

Schedule II requires companies to follow component accounting when the useful life of a component is different from that of its principal asset. However, class-3 companies are required to follow the useful life specified for the principal asset in Schedule II (which has no component-wise useful lives). This appears to be an apparent conflict in Schedule II.

The application of component accounting is likely to significantly alter accounting for replacement costs. Currently, companies expense such costs in the year of incurrence. Under component accounting, companies will capitalise these costs, consequently expensing the net carrying value of the replaced part.

Other changes include simplified calculation of double- and triple-shift depreciation and allowing the unit of production method.

Overall, many companies will be significantly impacted (negatively in many cases) owing to the pruning of useful lives and the adverse impact of transitional provisions.