

Depreciation under Companies Act 2013 and its Impact on Cost

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Synopsis

- What is Depreciation
- What is Depreciable Asset
- Various Methods of Depreciation
- Depreciation under Old Companies Act vs New Companies Act.
- Component Accounting.
- Impact of transition.
- CAS – 16 on Depreciation
- Its impact on cost.
- Its presentation in Cost Records and Audit Report

Definitions

- The monetary value of an asset decreases over time due to use, wear and tear or obsolescence. This decrease is measured as depreciation.
- A method of allocating the cost of a tangible asset over its useful life.
- ***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. (AS-6).***
- As per the Companies Bill, Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life (including amortization)

In accountancy, **depreciation** refers to two aspects of the same concept:

- the decrease in value of assets (fair value depreciation), and
- the allocation of the cost of assets to periods in which the assets are used (depreciation with the matching principle).

Definitions Contd

- **Depreciation** is a non-cash expense that reduces the value of an asset over time. Assets depreciate for two reasons:
 - **Wear and tear.** For example, an auto will decrease in value because of the mileage, wear on tires, and other factors related to the use of the vehicle.
 - **Obsolescence.** Assets also decrease in value as they are replaced by newer models. Last year's car model is less valuable because there is a newer model in the marketplace.

Depreciable assets

Depreciable assets are assets which

- (i) are expected to be used during more than one accounting period; and
- (ii) have a limited useful life; and
- (iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and **not for the purpose of sale in the ordinary course of business.**

The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.

Methods of Depreciation

- Straight-line depreciation
- Declining Balance Method
- Annuity depreciation
 - i) Annuity depreciation methods are not based on time, but on a level of Annuity.
 - ii) This could be miles driven for a vehicle, or a cycle count for a machine.
- Units-of-production depreciation method
- Units of time depreciation

Assets not covered under Schedule II

- (i) forests, plantations and similar regenerative natural resources;
- (ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;
- (iii) expenditure on research and development;
- (iv) goodwill and other intangible assets;
- (v) live stock.

This standard also does not apply to land unless it has limited useful life for the enterprise.

Factors Determining Depreciation

- i. Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;
- ii. Expected useful life of the depreciable asset; and
- iii. Estimated residual value of the depreciable asset.

Many times Useful Life of Asset can be shorter than Physical Life

- i. Pre-determined by legal or contractual limits, such as the expiry dates of related leases;
- ii. Directly governed by extraction or consumption;
- iii. Dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
- iv. Reduced by obsolescence arising from such factors as:
 - a) technological changes;
 - b) improvement in production methods;
 - c) change in market demand for the product or service output of the asset; or
 - d) legal or other restrictions.

Old V\ s New Companies Act

Sl.	The Companies Act, 1956	The Companies Bill, 2013
1	Section 205 and 350 governs the ascertainment of Depreciation with reference to Schedule XIV	Schedule II of the Companies Bill 2013 contains the provisions for “Useful lives to Compute Depreciation”
2	The Companies Act, 1956 requires depreciation to be provided on each depreciable asset so as to write-off 95% of its original cost over a specified period. The remaining 5% is treated as residual value.	The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value (generally not more than 5%)
3	The Schedule XIV to the Companies Act, 1956 prescribes the rates of Straight Line Method and Written down Value at which depreciation on various assets need to be provided.	Only useful life is provided , therefore the entity is required to calculate the appropriate rate of depreciation as per the method used by it (SLM or WDV)

Old v\ s New..... Contd

S1.	The Companies Act, 1956	The Companies Bill, 2013
4	Schedule XIV provides separate depreciation rates for double shift and triple shift use of assets.	No separate rates are prescribed for extra shift depreciation. For the period of time an asset [other than NESD (No Extra Shift Depreciation)] is used in double shift, depreciation will increase by 50% and by 100% in case of triple shift working.
5	Unit of production (UOP) method for calculation of depreciation is not allowed as per circular issued by MCA.	The useful life of an asset can be the number of production or similar units expected to be obtained from the asset. This indicates that a company may be able to use UOP method for depreciation.
6	Assets whose actual cost does not exceed Rs. 5000/- are depreciated @ 100%.	There is no specific requirement for providing depreciation on assets whose actual cost does not exceed Rs.5000/-
7	Treatment for Depreciation on intangible Assets was notified by MCA in its circular dated 17th April 2012.	No separate depreciation rate is prescribed for Intangible assets. The same will be governed by Accounting Standards.

Class of Companies and Depreciation

Sr.	Class of companies as may be prescribed and whose financial statements comply with the Accounting Standards	Other Companies
1	such class of companies will use useful lives and residual values prescribed in the Part “C” of schedule II	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 the proposed Schedule.
2	permitted to adopt a different useful life or residual value for their assets, provided they disclose justification for the same.	They cannot follow useful life cannot be longer than given in Part “C” of schedule II and same way residual value of asset cannot be higher.

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

Component Accounting

- Where the cost of a part of asset is significant to total cost of 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.
- Under AS 10, there seems to be a choice in this matter; however, the Companies Act, 2013 requires application of component accounting mandatorily when relevant and material.

Transitional Provisions

- The transitional provision requiring remaining carrying value to be depreciated over remaining useful life.
- This suggest that all the existing assets to be brought to the WDV as if Companies Act 2013 was applicable Ab-initio.
- The WDV needs to be depreciated in the remaining useful life.
- In case, no useful life is left, whole amount is charged to Retained Earning without routing through P&L.

Some Effects of Transitional Provisions

Situation A

- Remaining useful life – 1 Year
- Remaining Carrying Value – 60% of GB

Effect - whole 60% shall be booked as depreciation to Profit and Loss Account.

This will affect Profit and Loss Account

Some Effects of Transitional Provisions

Situation B

- Remaining useful life – Nil
- Remaining Carrying Value – 40% of GB

Effect whole 40% shall be charged to Retained Profits.

This will affect Balance Sheet

Depreciation on Buildings

	2013		1956	
Nature of Assets	Useful Life Years	Rate [SLM]	Useful Life Years	Rate [SLM]
I Buildings [NESD]		%		%
(a) Building (other than factory buildings) RCC Frame Structure	60	1.58	58	1.63
(b) Building (other than factory buildings) other than RCC Frame Structure	30	3.17	58	1.63
(c) Factory buildings	30	3.17	28	3.34
(d) Fences, wells, tube wells	5	19.00	58	1.63
(e) Other (including temporary structure, etc.)	3	31.67	1	100
II Bridges, culverts, bunkers, etc. [NESD]	30	3.17	58	1.63
III Roads [NESD]				
(a) Carpeted Roads				
(i) Carpeted Roads - RCC	10	9.50	58	1.63
(ii) Carpeted Roads - other than RCC	5	19.00	58	1.63
(b) Non-carpeted roads	3	31.67	58	1.63

Depreciation on P&M

Plant and Machinery	2013		1956	
Nature of Assets	Useful Life Years	Rate [SLM]	Useful Life Years	Rate [SLM]
General rate applicable to Plant and Machinery not covered under Special Plant and Machinery				
(i) Plant and Machinery other than continuous process plant not covered under specific rate has been prescribed.	15	6.33%	20	4.75%
(ii) Continuous process plant for which no special rate has been prescribed.	25	3.80%	18	5.28%

“Continuous process plant” means a plant which is required and designed to operate for 24 hours a day.

Depreciation for Special Industry - Glass

Plant and Machinery used in glass	2013		1956	
Nature of Assets	Useful Life Years	Rate [SLM]	Useful Life Years	Rate [SLM]
1. Plant and Machinery except direct fire glass melting furnaces - Recuperative and regenerative glass melting furnaces	13	7.31%	6	16.21%
2. Plant and Machinery except direct fire glass melting furnaces - Moulds [NESD]	8	11.88%	8.5	11.31%
3. Float Glass Melting Furnaces [NESD]	10	9.50%	9.5	10.00%

Depreciation on Vehicles

Motor Vehicles [NESD]	2013		1956	
Nature of Assets	Useful Life Years	Rate [SLM]	Useful Life Years	Rate [SLM]
Motor cycles, scooters and other mopeds.	10	9.50%	10	9.50%
Motor Cars other than those used in a business of running them on hire.	8	11.88%	10	9.50%
Motor buses, motor lorries, motor car sandmotor taxis used in a business of running them on hire.	6	15.83%	5.9	16.21%
Motor buses, motor lorries, motor cars and motor taxis other than those used in a business of running them on hire.	8	11.88%	8.5	11.31%
Motor tractors, harvesting combines and heavy vehicles.	8	11.88%	8.5	11.31%
Electrically operated vehicles including battery powered or fuel cell powered vehicles.	8	11.88%	13.5	7.07%

Depreciation on Furniture and Computer

I. Furniture and fittings [NESD]	2013		1956	
Nature of Assets	Useful Life Years	Rate [SLM]	Useful Life Years	Rate [SLM]
General furniture and fittings	10	9.50%	15	6.33%
Furniture and fittings used in hotels, restaurants and boarding houses, schools, colleges and other education institutions, libraries, welfare centres, meeting halls, cinema houses, theatres and circuses and furniture and fittings let out on hire for used on occasion of marriages and similar functions	8	11.88%	10	9.50%
II. Computers and data processing units [NESD]				
i) Servers and networks	6	15.83%	5.8	16.21%
ii) End user devices, such as, desktops, laptops, etc.	3	31.67%	5.8	16.21%

Industries with Special Rates

Industries for Which Special Rates are prescribed under Schedule II	
(i)	Plant and Machinery related to production and exhibition of Motion Picture Films
(ii)	Plant and Machinery used in glass
(iii)	Plant and Machinery used in mines and quarries Portable underground machinery and earth moving machinery used in open cast mining
(iv)	Plant and Machinery used in Telecommunications [NESD]
(v)	Plant and Machinery used in exploration, production and refining oil and gas [NESD]
(vi)	Plant and Machinery used in generation, transmission and distribution of power [NESD]
(vii)	Plant and Machinery used in manufacture of
	1. Sinter Plant
	2 . Blast Furnace
	3. Coke Ovens
	4. Rolling mill in steel plant
	5. Basic Oxygen Furnace Converter
(viii)	Plant and Machinery used in manufacture of non ferrous metals
(ix)	Plant and Machinery used in medical and surgical operations [NESD]surgical operations [NESD]
(x)	Plant and Machinery used in manufacture of pharmaceuticals and chemicals [NESD]
(xi)	Plant and Machinery used in civil construction
(xii)	Plant and Machinery used in salt works [NESD]

CAS-16 Depreciation

Depreciation (Definition)

1. Depreciation is a measure of the –

- wearing out,
- consumption or other loss of value of a depreciable asset arising from use,
- efflux of time or
- obsolescence through technology and market changes.

2. **Depreciable amount** of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Depreciable Asset and Residual Value

- 1) Depreciable fixed and Intangible assets are assets which:
 - i. are expected to be used during more than one accounting period;
 - ii. have a limited useful life; and
 - iii. are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.
- 2) Residual (salvage) value: Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Useful life of asset

Useful life of asset is either

- (i) the period over which a depreciable asset is expected to be used by the enterprise; or
- (ii) the number of production or similar units expected to be obtained from the use of the asset by the entity

Calculation of Depreciation

Depreciation and Amortisation shall be measured based on the depreciable amount and the useful life.

The residual value of an intangible asset shall be **assumed to be zero** unless:

- a) there is a commitment by a third party to purchase the asset at the end of its useful life; or
- b) there is an active market for the asset and:
 - i. residual value can be determined by reference to that market; and
 - ii. it is probable that such a market will exist at the end of the asset's useful life.
 - iii. The residual value of a fixed asset shall be considered as **zero if the entity is unable to estimate the same with reasonable accuracy**.

Depreciation Subject to

- The minimum amount of depreciation to be provided shall not be less than the amount calculated as per principles and methods as prescribed by any law or regulations applicable to the entity and followed by it.
- In case of regulated industry the amount of depreciation shall be the same as prescribed by the concerned regulator.

Other Significant Points

- Depreciation of any addition or extension to an existing depreciable asset which becomes an integral part of that asset shall be based on the remaining useful life of that asset.
- **The impact of higher depreciation due to revaluation of assets shall not be assigned to cost object.**
- **Impairment loss on assets shall be excluded from cost of production.**
- **Depreciation on an asset which is temporarily retired from production of goods and services shall be considered as abnormal cost for the period when the asset is not in use.**
- Spares purchased specifically for a particular asset, or class of assets, and which would become redundant if that asset or class of asset was retired or use of that asset was discontinued, shall form part of that asset. The depreciable amount of such spares shall be allocated over the useful life of the asset.

Significant Points..... Contd

- Cost of small assets shall be written off in the period in which they were purchased as per the accounting policy of the entity.
- Depreciation of an asset shall not be considered in case cumulative depreciation exceeds the original cost of the asset, net of residual value.

Impact on Cost

- There is going to be major difference in the depreciation provisioning.
- As at many places, useful life of assets is reduced significantly. For example,
 - Plant and Machinery for other than Continuous Process Plant is reduced to 15 years from 20 years earlier.
 - In case of buildings, Roads, Borewell, etc. useful life is reduced drastically. For example, in case of Fences, wells, tube wells useful life is reduced to 5 years from 58 years earlier.
- As discussed in transitional changes, the remaining value of the assets will be depreciated in the remaining life of the asset. This may result in very high depreciation for some of the industries.
- As study goes, depreciation is very significant portion of operational cost, in case of capital intensive industries. Cost impact will be very high for such industries.

Impact on Cost...Contd

Question 1:

The ICAI *Guidance Note on “Treatment of Reserve Created on Revaluation of Fixed Assets”* clarifies that for statutory purposes, such as, dividends and managerial remuneration, only depreciation based on historical cost of the fixed assets needs to be provided out of current profits of the company. This reduces the impact of depreciation charge to the P&L account on account of revaluation. What is required under the 2013 Act?

Answer:

In case of revaluation, depreciation will be based on the revalued amount. Consequently, the ICAI guidance may not apply and full depreciation on the revalued amount is expected to have significant impact on the P&L.

Impact on Cost...Contd.

Question 2:

The 2013 Act requires that depreciation should to be provided even on the revalued amount of fixed assets. If so, what will be the use of revaluation reserve? Can a company transfer the same to retained earnings?

Answer:

AS 10 states that on disposal of a previously revalued item of fixed asset, the amount standing in revaluation reserve relating to the asset sold may be transferred to general reserve. One of the implications of the 2013 Act is that it is not possible for companies to recoup additional depreciation charged to P&L, out of revaluation reserve as is allowed under the ICAI Guidance note on *"Treatment of Reserve Created on Revaluation of Fixed Assets"*. However, there is no prohibition on transfer to general reserve. Hence, in such cases, the amount standing credit to revaluation reserve in respect of an item of fixed asset may be transferred directly to general reserve. A company may transfer whole of the reserve when the asset is sold or disposed of. Alternatively, it may transfer proportionate amount as the asset is depreciated.

Effect on Cost Audit Report

- There is going to be major difference in the depreciation provision. This may be shown under auditor's observations.
- Alternatively, a call may be taken to consider the same as non-cost, if the same is materially affecting the cost.
- Performance Appraisal Report should also include impact of change in depreciation on cost of production and cost of sales.
- We may expect some guideline from our institute in this regard.

Thank You

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