Component Approach of Accounting of Depreciation and Transitional Effect as per the Companies Act, 2013

The new method of depreciation on the basis of useful life of asset as per Schedule-II of the Companies Act, 2013 has became operational from 1st April, 2014 vide MCA Notification No. S.O. 902(E) dated 26th March, 2014. Schedule-II of the Companies Act, 2013 prescribed the useful life of individual assets for the purpose of depreciation on fixed asset. Now, the Companies Act, 2013 introduce a component approach for accounting of depreciation as envisaged in Ind AS-16 "Property, Plant and Equipment" which was not covered earlier by the Companies Act, 1956. As far as the applicability of Schedule-II of the Companies Act, 2013 is concerned, there will be a significant transitional effect on opening retained earnings as well as current year's profit of the entity. The topics covered under this article aim to clarify the Component Approach of Accounting of Depreciation and Transitional Effect of Schedule-II on the present financial statement.

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Component Approach of Accounting of Depreciation

Component Accounting of Fixed Asset

Indian Accounting Standard-16 (Ind As-16) (Property, Plant and Equipment) specifies in Para 43 to 47 the component accounting of fixed asset. Those read as follows:

> *Para-43: Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.*
>
> *Para- 44: An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate*

separately the airframe and engines of an aircraft, whether owned or subject to a finance lease. Similarly, if an entity acquires property, plant and equipment subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms.

Para-45: A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

Para-46: To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.

Para-47: An entity may choose to depreciate separately the parts of an item that do not have a cost that is significant in relation to the total cost of the item.

Note-4 of Schedule-II of the Companies Act, 2013

Note-4 of Schedule-II of the Companies Act, 2013 specified that:

"Useful life specified in Part C of the Schedule is for whole of the asset. Where 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 shall be determined separately."

Thus, where one Fixed Asset comprises of different items of fixed assets which are significant to the total cost of main asset and their useful life is different from the useful life of main asset. Depreciation in respect of such different items of fixed assets is required to be calculated by their respective useful life.

Illustration-1

X ltd., a steel manufacturing industry commissioned a power plant at its steel plant at a cost of ₹700/- crore. The cost break up of ₹700/- crore is as follows:

Components	Cost (In ₹ crore)	Useful life
Erection, fabrication & construction of Building Structure	100	30
Electrical Panels Installation	50	10
Plant &Equipments (Boiler, Turbine, Generator, condenser etc)	500	40
Transformer, grids	50	10

As per the Companies Act, 1956, depreciation per annum will be:

- @ 4.75% (As per SLM method of Single Shift) *i.e.* ₹700/- x 4.75% = ₹33.25/- crore
- @10.34% (As per SLM method of Triple Shift) *i.e.* ₹700/- x 10.34% = ₹72.38/- crore

Whereas, as per the Companies Act, 2013 depreciation will be calculated component wise *i.e.,* each component will be treated as separate item. After considering 5 % Residual Value depreciation will be as follows:

₹ in crore

Components	Cost	Useful life	Depreciable Amount (After 5% Residual Value)	Depreciation p.a.
I	II	III	IV (II x 95%)	V=IV/III
Erection, fabrication & construction of Building Structure	100	30	95.00	3.17
Electrical Panels Installations	50	10	47.50	4.75
Plant &Equipments (Boiler, Turbine, Generator, condenser etc)	500	40	475.00	11.88
Transformer, grids	50	10	47.50	4.75
Total Depreciation				**24.55**

Hence, as per the Companies Act, 1956 each individual asset is depreciated with main asset and as far as the Companies Act, 2013 is concerned each component of main asset is depreciated over their respective useful life if that component is significant

to the total cost of main asset and useful life of that component is different from the useful life of the main asset.
It is pertinent to note the provision contained in the Companies Act 2013, read with Schedule-II, Note-4

"Useful life specified in Part C of the Schedule is for whole of the asset. Where 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 shall be determined separately".*

The main essentials of the component approach of accounting are:

- one part of the asset is significant to total cost of main asset and
- useful life of that part is different from the useful life of the remaining asset.

What is the meaning of 'significant' in this context is not defined in the Companies Act, 2013 as well as in Ind AS-16?

Significance of the component of the asset in comparison to the cost of main asset is the subject matter of entity's practices or policies, because the Companies Act, 2013 does not clarify the meaning of significance in the context of depreciation.

Identification of component and their useful life is most important factor for the company as well as identification of asset for which component accounting is applicable is a subject matter of company's practice or policy.

Accounting Approach for Assets having Insignificant Cost

The Companies Act, 2013 only prescribed for component approach of accounting for those assets which are significant in comparison to main asset. It is silent about depreciation of those assets whose cost is insignificant to the cost of main asset. However, para-46 & 47 of Ind As-16 prescribed for accounting of depreciation of those parts of main asset which are insignificant.

"Para-46: To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts."

Para-47: An entity may choose to depreciate separately the parts of an item that do not have a cost that is significant in relation to the total cost of the item.

Treatment for depreciation of insignificant component of main asset prescribed in Ind AS is neither covered in Companies Act, 2013 nor in AS-6.

In view of the silent provision contained in the Companies Act, 2013, company may depreciate its insignificant component of main asset over the useful life of main asset. Whereas, Ind-AS-16 envisaged on formation of "remainder" which will club insignificant asset in one block and depreciation of such remainder is depend upon *consumption pattern and/or useful life of insignificant asset which are clubbed in remainder.*

Illustration-2

Considering the facts and figures of Illustration-1, component accounting of plant and machinery *i.e.* power plant will be done when each component of main asset *i.e.* Building Structure, Electrical Installation *etc.* are significant to main power plant. If, for example, Electrical Installation is insignificant to the total cost of main asset *i.e.* power plant then depreciation will be:

A. As per the Companies Act,2013 **₹ in crore**

Components	Cost	Useful life	Depreciable Amount (After 5% Residual Value)	Depreciation p.a.
I	II	III	IV (II x 95%)	V=IV/III
Erection, fabrication & construction of Building Structure	100	30	95.00	3.17
Plant & Equipments (Boiler, Turbine, Generator, Condenser *etc* & Electrical Installation)	550	40	522.50	13.06
Transformer, grids	50	10	47.50	4.75
Total	**700**			**20.98**

B. As per Ind AS-16 (Para-46 and 47) ₹ in crore

Components	Cost	Useful life	Depreciable Amount (After 5% Residual Value)	Depreciation p.a.
I	II	III	IV (II x 95%)	V=IV/III
Main Component				
Erection, fabrication & construction of Building Structure	100	30	95.00	3.17
Plant & Equipments (Boiler, Turbine, Generator, condenser *etc*)	500	40	475.00	11.88
Transformer, grids	50	10	47.50	4.75
Remainder (Insignificant Assets)				
i. Electrical Panels Installations	50	10*	47.50	4.75
Total Depreciation				**24.55**

* Depends upon the consumption pattern and/or useful life of remainder.

Hence, from the above example, it is clear that, if one component of main asset which is insignificant to the cost of main asset, useful life of main asset will be considered as the useful life of the insignificant component for depreciation as per the Companies Act, 2013.

Whereas, Ind AS-16 specifically mentioned the useful life of remainder which is not at par with useful life of the main asset, but it will depend upon consumption pattern and/or useful life of the remainder itself.

Retrospective Effect for Component Approach of Accounting

The Companies Act, 2013 did not provide for retrospective adjustment/effect in the books of account in view of the new Schedule-II to the Companies Act, 2013. But, as far as accounting is concerned, Accounting Standards-6 "Depreciation Accounting" contains provision regarding retrospective adjustment of depreciation by virtue of requirement of new statute.

Hence, the component approach of accounting in respect of fixed asset is required to be incorporated in the books of accounts from the date original asset came into existence.

After recalculation of asset as per useful life prescribed in Schedule-II of the Companies Act, 2013 certain amount is required to be charge from the opening retained earnings as well as certain amount is required to be charged to statement of Profit & Loss for the current year which is described in Part-II.

Transitional effect of Depreciation as per Schedule-II of the Companies Act, 2013

Para- 21 of AS-6, (Depreciation Accounting)

Para- 21 of AS-6, Depreciation Accounting reads as follows:

> *"The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change*

Where one Fixed Asset comprises of different items of fixed assets which are significant to the total cost of main asset and their useful life is different from the useful life of main asset

should be treated as a change in accounting policy and its effect should be quantified and disclosed.

Notes-7 to the Schedule-II of the Companies Act, 2013

Notes-7 to the Schedule-II of the Companies Act, 2013 reads as follows:

"From the date this Schedule comes into effect, the carrying amount of the asset as on that date—

(a) shall be depreciated over the remaining useful life of the asset as per this Schedule;

(b) after retaining the residual value, shall be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil."

The Companies Act, 2013 vs. AS-6 "Depreciation Accounting"

As per the requirement of AS-6, retrospective calculation of depreciation on existing fixed asset as per requirement of new act is required to be carried out and the deficiency or surplus by virtue the change in method should be charged to Statement of Profit & Loss.

Whereas, Note-7 to the Schedule-II of the Companies Act, 2013 prescribed that, if an asset having some carrying amount in books as on the date of implementation of the Companies Act, 2013 with 'NIL' useful life, then after keeping some residual value entire carrying amount should be charged to opening retained earnings. If asset is having some useful life then asset will be depreciated over remaining useful life of the asset:

Fixed asset having carrying Amount as on 01/04/2014

If Useful life as on 01/04/2014 is "NIL" → Carrying Amount is charged to Opening Retained Earnings

If useful life exists → Asset will be depreciated over its remaining useful life

AS-6 and the Companies Act, 2013 both are contradicting each other in following points.

- *The Companies Act, 2013 does not envisaged on retrospective adjustment of depreciation. Whereas, AS-6 envisaged on retrospective adjustment of depreciation.*
- *The Companies Act, 2013 envisaged in adjustment from opening retained earnings of carrying amount where useful life is nil. Whereas AS-6 only emphasise in charging in the current year profit and loss a/c.*

Illustration: 3

X ltd, purchased furniture on following years.

Sl. No.	Particulars	If Purchased on 31st March, 2004	If Purchased on 31st March, 2005
1	Furniture purchase cost	100.00	100.00
2	No of year used as on 1st April, 2014	10	9
3	Depreciation charged as per the Companies Act, 1956 (@ 6.33% pa as on 1st April, 2014	63.30	56.97
4	Net Carrying Amount as on 1st April, 2014	36.70	43.03
5	Useful life as per CA-2013 (years)	10	10
6	Residual Value presumed @ 5%	5.00	5.00
7	Remaining useful life as on 1st April, 2014	0.00	1.00
8	Amount to be charged to opening retained earnings after retaining residual value	31.70	0.00
9	Depreciation as per the Companies Act, 2013	0	38.03

From the above example, it has been clearly understood that only due to change in the year, a huge amount will be charged to opening retained earning *i.e.* when furniture purchased on 31st March, 2004 entire carrying amount is charged to opening retained earnings. Whereas, furniture purchased after one year *i.e.* on 31st March, 2005 carrying amount is charged to statement of profit and loss.

Table-1 below shows specific assets which have nil useful life as on 1st April, 2014. Hence, carrying amount in respect of these assets should be charged to opening retained earnings.

Table-1

Impact of Note-7 (b) of Schedule-II of the Companies Act 2013 on retained earnings due to following Assets					
		Companies Act, 2013		**Companies Act, 1956**	
Sl. No.	**Nature of assets**	**Useful Life As per Sch-II**	**Depreciation rate after considering 5% residual value (%)**	**Depreciation (%)**	**Asset Capitalise upto (Approx)**
A	**B**	**C**	**D**	**E**	**F**
I	***BUILDINGS (NSED)***				
(b)	Buildings (other than factory buildings) other than RCC Frame Structure	30	3.17	1.63	31-03-1984
(c)	Factory buildings	30	3.17	1.63	31-03-1984
(d)	Fences, wells, tube wells	5	19.00	1.63	31-03-2009
II	***Bridges, culverts, benders, etc. (NESD)***				
III	***Roads (NESD)***				
(a)	**Carpeted roads**				
(i)	Carpeted Roads-RCC	10	9.50	1.63	31-03-2004
(ii)	Carpeted Roads-other than RCC	5	19.00	1.63	31-03-2009
(b)	***Non-carpeted roads***	3	31.67	1.63	31-03-2011
IV	***Plant and Machinery***				
(i)	**General rate applicable to plant and machinery not covered under special plant and machinery**				
(a)	Plant and Machinery other than continuous process plant not covered under specific industries	15	6.33	4.75	31-03-1999
(b)	continuous process plant for which no special rate has been prescribed under (ii) below [NESD]	8	11.88	5.28	31-03-2006
(ii)	***Special Plant and Machinery***				
(a)	Plant and Machinery related to production and exhibition of Motion Picture Films				
1	Cinematograph films—Machinery used in the production and exhibition of cinematograph films, recording and reproducing equipments, developing machines, printing machines, editing machines, synchronisers and studio lights except bulbs	13	7.31	7.07	31-03-2001
2	Projecting equipment for exhibition of films	13	7.31	7.07	31-03-2001
(b)	***Plant and Machinery used in glass manufacturing***				
1	Plant and Machinery except direct fire glass melting furnaces Recuperative and regenerative glass melting furnaces	13	7.31	7.07	31-03-2001
2	Plant and Machinery except direct fire glass melting furnaces Moulds [NESD]	8	11.88	7.07	31-03-2006
(c)	Plant and Machinery used in mines and quarries—Portable underground machinery and earth moving machinery used in open cast mining [NESD]	8	11.88	11.31	31-03-2006
(d)	Plant and Machinery used in Telecommunications [NESD]	18	5.28		31-03-1996

Sl. No.	Nature of assets	Useful Life As per Sch-II	Depreciation rate after considering 5% residual value (%)	Depreciation (%)	Asset Capitalise upto (Approx)
1	Towers	18	5.28	4.75	31-03-1996
2	Telecom transceivers, switching centres, transmission and other network equipment	13	7.31	4.75	31-03-2001
3	Telecom—Ducts, Cables and optical fibre	18	5.28	4.75	31-03-1996
4	Satellites	18	5.28	4.75	31-03-1996
(e)	Plant and Machinery used in exploration, production and refining oil and gas [NESD]				
7	Field operations (above ground) Portable boilers, drilling tools, well-head tanks, *etc.*	8	11.88	11.31	31-03-2006
8	Loggers	8	11.88	4.75	31-03-2006
(f)	**Plant and Machinery used in generation, transmission and distribution of power** [NESD]				
(g)	**Plant and Machinery used in manufacture of steel**				
(h)	**Plant and Machinery used in manufacture of non-ferrous metals**				
(i)	**Plant and Machinery used in medical and surgical operations** [NESD]				
1	Electrical Machinery, X-ray and electrotherapeutic apparatus and accessories thereto, medical, diagnostic equipments, namely, Cat-scan, Ultrasound Machines, ECG Monitors, *etc.*	13	7.31	7.07	31-03-2001
2	Other Equipments.	15	6.33	4.75	31-03-1999
(j)	***Plant and Machinery used in manufacture of pharmaceuticals and chemicals [NESD]***				
(k)	***Plant and Machinery used in civil construction***				
1	Concreting, Crushing, Piling Equipments and Road Making Equipments				
2	Heavy Lift Equipments—				
	Cranes with capacity of less than 100 tons	15	6.33	4.75	31-03-1999
3	Transmission line, Tunnelling Equipments [NESD]	10	9.50	4.75	31-03-2004
4	Earth-moving equipments	9	10.56	4.75	31-03-2005
5	Others including Material Handling /Pipeline/ Welding Equipments [NESD]	12	7.92	4.75	31-03-2002
(l)	***Plant and Machinery used in salt works [NESD]***	15	6.33	4.75	31-03-1999
V.	***Furniture and fittings [NESD]***				
(i)	General furniture and fittings	10	9.50	6.33	31-03-2004
(ii)	Furniture and fittings used in hotels, restaurants and boarding houses, schools, colleges and other educational institutions, libraries; welfare centres; meeting halls, cinema houses; theatres and circuses; and furniture and fittings let out on hire for use on the occasion of marriages and similar functions.	8	11.88	9.5	31-03-2006
VI.	***Motor Vehicles [NESD]***				

Sl. No.	Nature of assets	Useful Life As per Sch-II	Depreciation rate after considering 5% residual value (%)	Depreciation (%)	Asset Capitalise upto (Approx)
3	Motor buses, motor lorries and motor cars other than those used in a business of running them on hire	8	11.88	11.31	31-03-2006
4	Motor tractors, harvesting combines and heavy vehicles	8	11.88	11.31	31-03-2006
5	Electrically operated vehicles including battery powered or fuel cell powered vehicles	8	11.88	7.07	31-03-2006
VII	***Ships [NESD]***				
1	Ocean-going ships				
(iii)	Chemicals and Acid Carriers:				
(x)	Hovercrafts	15	6.33	5	31-03-1999
2	Vessels ordinarily operating on inland waters—				
(i)	Speed boats	13	7.31	7.07	31-03-2001
(ii)	Other vessels	28	3.39	3.34	31-03-1986
IX	Railways sidings, locomotives, rolling stocks, tramways and railways used by concerns, excluding railway concerns [NESD]	15	6.33	4.75	31-03-1999
X	Ropeway structures [NESD]	15	6.33	4.75	31-03-1999
XI	Office equipment [NESD]	5	19.00	4.75	31-03-2009
XII	Computers and data processing units [NESD]				
(ii)	End user devices, such as, desktops, laptops, *etc.*	3	31.67	16.21	31-03-2011
XIII	Laboratory equipment [NESD]				
(i)	General laboratory equipment	10	9.50	4.75	31-03-2004
(ii)	Laboratory equipments used in educational institutions	5	19.00	4.75	31-03-2009
XIV	Electrical Installations and Equipment [NESD]	10	9.50	4.75	31-03-2004
XV	Hydraulic works, pipelines and sluices [NESD]	15	6.33	4.75	31-03-1999

From the above table, it is clear that asset purchased /capitalised upto the year mentioned in Column-D are having carrying amount in the books of account along with "NIL "useful life as on 31st March, 2014. Hence, as per the requirement of Note-7 of Schedule-II of the Companies Act, 2013, keeping some residual value in respect of above asset entire amount will be charged from retained earnings.

Identification of component and their useful life is most important factor for the company as well as identification of asset for which component accounting is applicable is a subject matter of company's practice or policy

Consequential Effect on Accounting Policy

Accounting Standard-5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies contents:

Para – 29: A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

Para - 32: Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect *of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.*

Due to the enactment of the Companies Act, 2013, there is requirement for change in accounting policy of the company. Hence, a change in the method of depreciation to useful life based depreciation, will lead the company towards assessment of impact of depreciation on financial statement of the company

The Companies Act, 2013 only prescribed for component approach of accounting for those assets which are significant in comparison to main asset

In view of the silent provision contained in the Companies Act, 2013, the company may depreciate its insignificant component of main asset over the useful life of main asset

and need to be disclosed in the notes of the financial statement of the company.

Conclusion

Hence, at the time of transition from the old Companies Act, 1956 to the new Companies Act, 2013, detailed evaluation of useful life of the asset and its carrying amount should be done as well as in the new era of deprecation identification of significant asset of main asset for component approach of accounting will push the company towards more detail evaluation of the project/fixed asset which are going to be capitalised during coming years or already capitalised during the previous years. ■