Depreciation…

From beginners to experts

Depreciation is being taught across first level accounting school and upto advanced level. The concept is gaining too much importance post changes brought under Companies Act, 2013. Schedule II of the Companies Act, 2013 provides Useful Lives to Compute Depreciation as against Rates of Depreciation provided hitherto in the Schedule XIV of the Companies Act, 1956. The author, after elaborating the basic concepts, explains the key provisions of this Schedule and concludes with takeaways. Read on ……….

As rightly said, depreciation is one of most common accounting term and is widely used by students, accountants and corporate. Depreciation is major component of total expenses and more particularly for companies with larger fixed assets base. The term 'depreciation' is in existence from years and perhaps no ambiguity has been left to deliberate upon. Then why is it gaining attention and has become the most talked about term, of late? This is because of changes brought under Companies Act, 2013. Number of queries is being raised by accountants and auditors, few of which have been resolved and balance left for wise interpretation. The situation has surfaced perhaps the basic concept on depreciation is being side lined and attempts are being made to reach at the conclusion directly.

Let us re-visit the learned concept!

Depreciation has been defined as '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'.

Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

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.

Principles of depreciation

Depreciable amount is the cost of the asset less the expected residual value. Cost of asset includes the base cost and other cost incurred specifically. In other words, it is the capitalisation amount arrived in accordance with the enterprise's accounting policy. Expected residual value is the estimated scrap value at the end of useful life of the asset.

Systematic allocation refers to method of allocating the depreciation amount over the accounting period. The allocation should reflect the pattern of asset being used by the enterprise. The two most common methods for providing depreciation are the Straight Line Method and the Reducing Balance Method. The selection of method should be after carefully considering nature of the asset and the conditions under which it is being used.

Under Straight Line Method, the depreciable amount is charged off every year equally so as to reduce the cost of the asset to nil or its residual value at the end of it useful life. The underline principle is that the asset generates equal utility over the life of asset.

Under Reducing Balance Method, a fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its break-up value at the end of its life. Under this method, the annual charge of depreciation decreases from year to year. This method takes into cognizance the pattern of repairs and wear-tear.

The depreciable amount needs to be allocated systematically over the asset's useful life. 'Useful Life' 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. Determination of the useful life is a matter of estimation and is normally based on various factors including experience with similar type of assets.

For example, a machine is purchased for INR 100,000. The residual value is estimated at INR 10,000 and the estimated useful life is 5 years. The per year depreciation allocation under straight line method will be:

Depreciation = Depreciable amount / Estimated useful life

INR 90,000/ 5 years = **INR 18,000 per year**

At last, the estimates used for determining the annual depreciation charge i-e the useful life and the expected residual value need to be reviewed or re-assessed at each reporting date.

Key takeaways from above principles

- ✓ Selection of depreciation method plays a vital role and it should be representative of the asset use.
- ✓ Key element for computing the annual depreciation charge is estimating the useful life of the asset.
- ✓ The assumptions need to be reviewed periodically.

Depreciation under Companies Act

After understanding the basic principles, we can now extend its application.

Quite often, the governing statue prescribes the guidelines on depreciation which the companies need to follow. Under the Companies Act, 1956, the depreciation rate for various classes of assets was specified. The objective was to set uniformity in financial reporting and to prevent companies from recording lower depreciation and thus declaring high profits and finally high dividend payout.

The depreciation rate specified under Schedule XIV of 1956 Act, were the minimum rates and the companies were allowed to charge higher depreciation in case the useful life of asset was estimated to be lower. This is also in accordance with the Accounting Standard. However, majority of companies have been following and adopted the rate as specified in Schedule XIV.

Companies Act, 1956 got replaced by Companies Act, 2013, as a reform measure. It was expected that the existing depreciation mechanism would be revised. This is rightly done through Schedule II of 2013 Act. The law makers have realised that prescribing the depreciation rate is perhaps ambiguous with the basic principles on depreciation and accordingly came out with the estimated useful life for various classes of asset. Thus, there is a change from rate regime to useful life. Further, the prescribed useful life is more indicative of exiting economic environment.

It is expected to have a significant impact on depreciation charge under both regimes. A comparison is being made as under:

Assets	Companies Act, 2013		Rate under Companies Act, 1956	Increase
	Useful Life	Deemed Rate		
Plant and Machinery	15	6.33%	4.75%	1.58%
Furniture and fittings	10	9.50%	6.33%	3.17%
Office Equipment	5	19.00%	4.75%	14.25%
Desktops, laptops, etc	3	31.67%	16.21%	15.46%
Electrical Installation	10	9.50%	4.75%	4.75%

The Schedule II is being notified from April 1, 2014 and would be applied first time for annual closing of year ending March 31, 2015. It has already undergone series of amendments and clarifications.

Snapshot of Schedule II

- Schedule II prescribes useful lives of various assets instead of SLM/ WDV rates.
- No life prescribed for other intangible assets. The Accounting Standard 26 to govern the same.
- All companies (except regulatory companies) can adopt useful lives/residual values which are **different** from schedule II provided the financial statements **shall disclose such difference** and provide **justification** in this behalf duly supported by **technical advice**.
- Useful life of **significant part** to be determined separately.
- No separate rate for double/ triple shift; depreciation to be increased by
  - ✓ 50% for the period of double shift use
  - ✓ 100% for the period of triple shift use
- No requirement to charge 100% depreciation on assets whose actual cost does not exceed INR 5,000
- Transitional provisions
  - ✓ If remaining useful life is not nil, carrying amount of the asset to be depreciated over the remaining useful life
  - ✓ If remaining useful life is nil by applying Schedule II, depreciable amount may be adjusted with retained earnings.

It is expected that the companies would apply the useful life as specified in Schedule II. However, they can still consider the different useful life based on the estimated useful life of their assets. Now whether the companies ***'can' or 'should'*** estimate the useful life is a matter of deliberation.

It is expected that companies who were using the hitherto Schedule XIV will switch over to Schedule II in entirety and will account for difference as per the transitional provisions.

Depreciation under Accounting Standard

Let us understand the specific provision of Accounting Standard.

Para 13 of AS 6 'Depreciation Accounting' states "The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute".

The above paragraph is suitably modified to incorporate provisions of Companies Act, 2013 for analysis.

In substance the Accounting Standard emphasis on estimated useful life. However, the requirement of governing statue i-e Companies Act to be also compiled.

Practical perspective – Useful Life & Residual Value

Example: 1

Useful life estimated by management 10 years

Life envisaged in Schedule II – 12 years

AS 6 requires life 10 years only

Company cannot use 12 years life of depreciation.

In Addition Schedule II require disclosure of justification for using lower life

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Example: 2

Useful life estimated by management 12 years

Life envisaged in Schedule II – 10 years

Company has an option to depreciate the assets either at

- ✓ 10 Years life as per schedule II or
- ✓ Estimated useful life 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.

Example: 3

Useful life estimated by management and AS 6 is 10 years **but Residual value is NIL**

Life envisaged in Schedule II – 10 years **with residual value of 5%**

In this case, AS 6 depreciation is the minimum threshold i.e. 10 Years

Company cannot use 5% of residual value

Schedule II requires disclosure of justification for using a lower residual value

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The fellow accountants and corporate house need to apply the combined principles of Schedule II and the Accounting Standard. Both cannot move in isolation.

Takeaway

Depreciation charge is not a matter of arithmetic calculation done on excel spreadsheet. Rather, it has underlying accounting principles and the provisions of relevant statue need to apply in spirit.

The suggestive roadmap for companies preparing accounts for FY 2014-15:

- Understand the existing policy on depreciation. Whether as per Schedule XIV or already using specific estimated useful life for classes of asset?
- *Assess whether the useful life as specified in Schedule II are more indicative for their assets or company need to do different estimation.*
- In case the useful life as per Schedule II gets applied – account for the transitional provision (to bridge the gap) and record resultant depreciation for the year.
- In case the existing useful life gets continued or the useful life is estimated as different from Schedule II – account for the yearly depreciation, account for the transitional provision (if required) and give required disclosures and provide justification duly supported by technical advice.

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