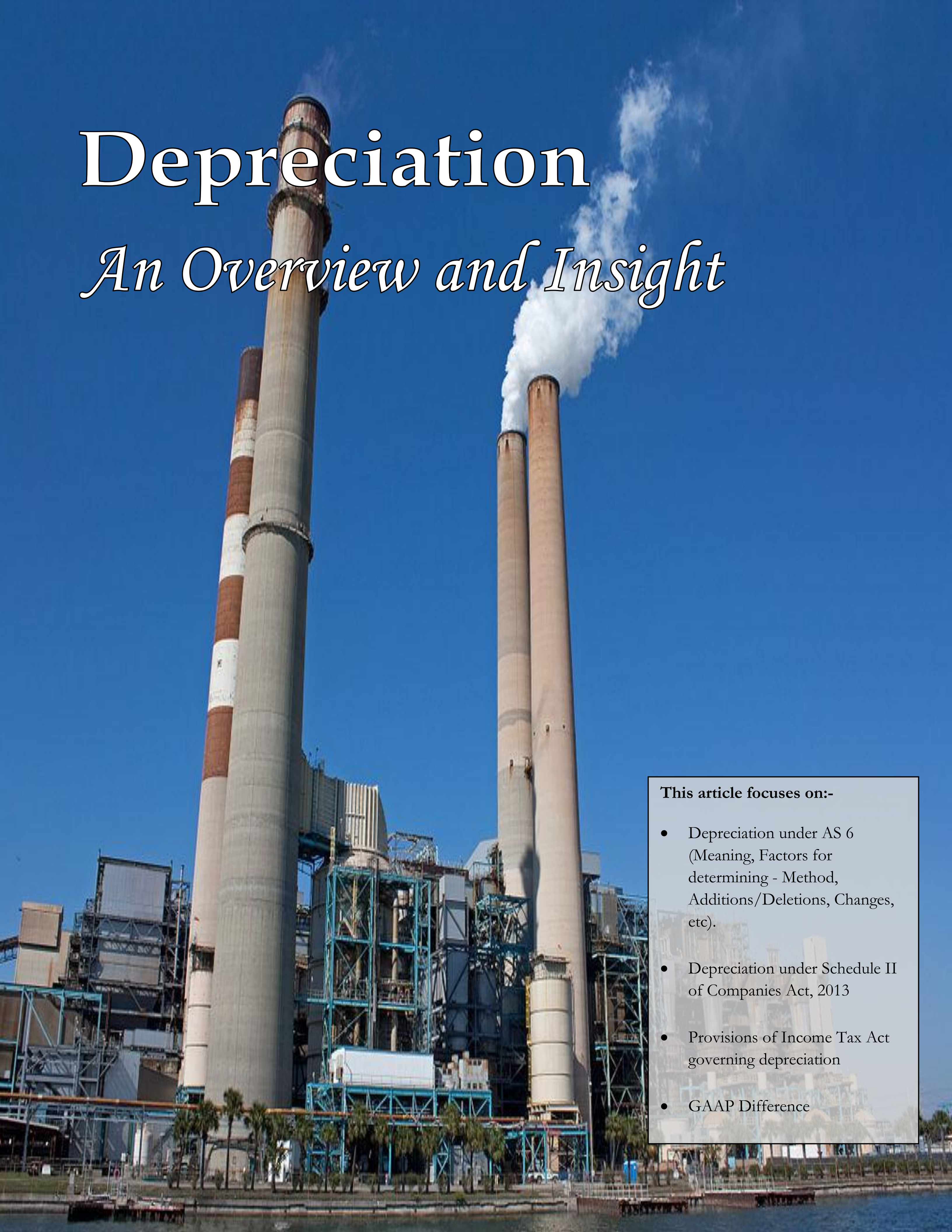
Depreciation

An Overview and Insight



This article focuses on:-

- Depreciation under AS 6 (Meaning, Factors for determining - Method, Additions/Deletions, Changes, etc).
- Depreciation under Schedule II of Companies Act, 2013
- Provisions of Income Tax Act governing depreciation
- GAAP Difference

1. Overview

The term 'depreciation' is in existence from years and it is considered among one of the most talked about subject in the field of accountancy. The subject of accounting for depreciation has always been a matter of crucial importance for the purpose of true and fair determination of the operating results of an entity and the depiction of the financial position through its profit and loss account and the balance sheet, respectively.

In simple words "Depreciation means reduction in the value of a fixed asset used in the business due to wear and tear and effluxion of time."

Depreciation is accounted by the entity to:-

- recover the cost incurred on fixed assets over its life
- facilitate the purchase of new asset when the old asset is disposed
- determine the correct profit or loss for the particular period
- determine correct financial position through balance sheet
- To keep the capital intact

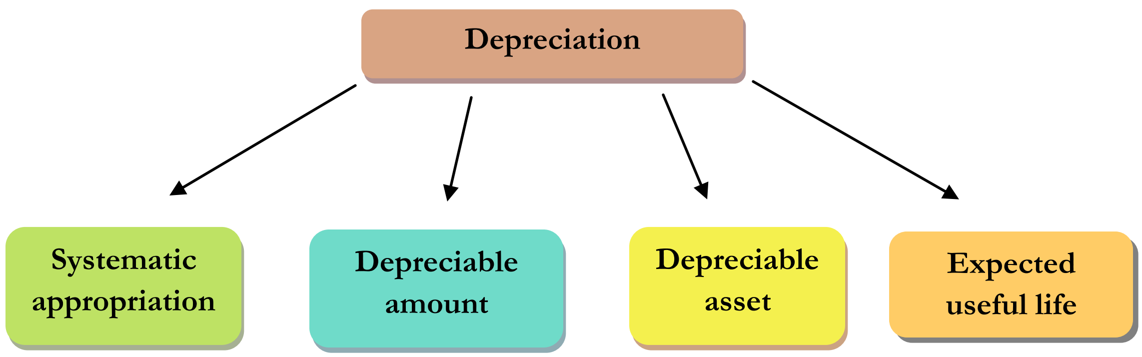
2. Depreciation under AS 6 "Depreciation Accounting"

Accounting Standard (AS)-6 has laid some principles on which the concept of depreciation is built. So, let's go through AS-6 and understand certain meanings and important concepts explained by it.

a) Meaning

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.

Depreciation is *systematic apportionment* of *depreciable amount* of *depreciable asset* over its *expected useful life* for each accounting period.



Depreciable assets[1] 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.

Useful life[2] is either

(i) the period over which a depreciable asset is expected to be used; or

(ii) the number of production or similar units expected to be obtained from the use of the asset.

Depreciable amount[3] of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

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[1] Clause 3.2 of AS 6 "Depreciation Accounting"

[2] Clause 3.3 of AS 6"Depreciation Accounting"

[3] Clause 3.4 of AS 6"Depreciation Accounting"

b) Factors for assessment of depreciation

Historical cost	Expected Useful life*	Estimated Residual Value*
• **Meaning** *Money outlay* in connection with its *acquisition, installation and commissioning* as well as for additions to or improvement thereof. • **Change in Historical cost** When there is Increase or decrease in long term liability on account of *exchange fluctuations, price adjustments, changes in duties or similar factors.*	**Determination of the useful life** of a depreciable asset is a matter of estimation but some of the factors which can be used for determination of useful life are:- • *expected usage* of the asset. • *expected physical wear and tear.* • *technical or commercial obsolescence* • *legal or similar limits* on the use of the asset • experience with *similar types of assets.*	**Determination** • If residual value is considered as *insignificant*, it is normally regarded as *nil.* • One of the bases for *determining the residual value* would be the *realizable value of similar assets* which have reached the end of their useful lives and have operated under similar conditions. • Generally, Companies take residual value of the asset as 5% of the cost of the asset.

*Useful life and Residual Value can undergo changes. So, they should be reviewed regularly.

c) Methods of Depreciation

There are several methods of allocating depreciation over useful life of the assets.

The management of a business selects the most appropriate method(s) based on various important factors e.g.

(i) Type of asset,

(ii) The nature of the use of such asset and

(iii) Circumstances prevailing in the business.

Various Methods of Depreciation		
Straight Line Method	Written Down Value Method	Machine Hour Method
Depletion Method	Sinking Fund Method	Annuity Method

Out of the above methods, Straight Line Method and Written down Value Method are most commonly adopted.

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 its useful life. The underline principle is that the asset generates equal utility over its life.

Under ***Written Down Value 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.

d) Addition to the Asset

Any addition to asset which is integral should be depreciated over remaining useful life of asset. If addition is not integral, asset should be separately depreciated.

e) Change in Method of Depreciation[1]

If there is any change in method of depreciation, the depreciation is recalculated and the change is done retrospectively. Any surplus or deficiency on account of change is adjusted in Statement of Profit and Loss.

3. Depreciation under Companies Act

With the introduction of Companies Act, 2013, the provisions governing charge of depreciation in the erstwhile Schedule XIV to the Companies Act, 1956 have been replaced with Schedule II to the Companies Act, 2013.

Key *aspects of Schedule II to the Companies Act 2013* are follows:-

Schedule II prescribes indicative ***useful lives*** of various assets for calculating depreciation.

[1] Clause 15 of AS 6"Depreciation Accounting"

Useful lives of fixed assets prescribed under schedule II are Act different from those envisaged under Schedule XIV of the Companies Act, 1956.

This can be further explained with the following table:-

Assets	Companies Act, 2013		Rates under Companies Act, 1956	Increase
	Useful Life	Derived 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 useful life of an asset shall not ordinarily be different from the useful life specified in Part C of Schedule II and the residual value of an asset shall not be more than five per cent of the original cost of the asset.

However, *all companies now will have an option to have useful life and residual value of the assets which could be different from the useful life and residual value prescribed in the Schedule II.*

But it is very important to keep in mind that in case the Company uses a different useful life (higher or lower) or a residual value of more than five percent, then it will have to ***disclose such difference*** and provide ***justification*** in this behalf in the financial statements. Such justification should be supported by ***technical advice.***

a) Useful lives are prescribed for **tangible assets only**. No life is prescribed for intangible assets an shall be governed by AS 26.

b) Transitional Depreciation

From the date of Schedule II coming into effect i.e. 1 April 2014, Companies have to calculate remaining useful life of its assets as on March 31, 2014.

After assessing the remaining residual value, the carrying amount of the asset as on that date shall be depreciated over the remaining useful life of the asset after retaining the residual value.

But, if the remaining useful life as on March 31, 2014 is *nil*, then the residual value, may be recognized in the *opening balance of retained earnings or may be charged off to Statement of Profit and Loss.*

Let's understand it with an example:

Useful Life of General Furniture and Fittings has been reduced from 15 years to 10 years. Consider the below scenarios for different age of a piece of furniture on the date of applicability of Schedule II –

- The furniture is 8 years old – The remaining WDV of the furniture shall be depreciated over the remaining 2 years.
- The furniture is 12 years old – Company has an option of charging the remaining WDV of the furniture to the retained earnings of the company or charging the same to the Statement of Profit and Loss.

The above application is fairly simple if the company uses straight line method (SLM). However, if a company uses ***Written Down Value (WDV) method*** of depreciation, it will need to calculate a new *rate for depreciation* to depreciate the asset over their remaining useful life using the formula reproduced below:-

R= {1 – (s/c) ^1/n} x 100

Where,
R = Rate of Depreciation (in %)
n = Remaining useful life of the asset (in years)
s = Scrap value at the end of useful life of the asset
c= Cost of the asset/Written down value of the asset

c) No separate rate for ***double/ triple shift***. For this, depreciation to be increased should be based on the double shift/ triple shift use of the assets.
Like 50 per cent for the period of double shift use and 100 per cent for the period of triple shift use.

4. Depreciation under Income Tax Act, 1961

Let's check out the ***key points*** laid down by the Income Tax Act regarding depreciation.

a) Under section 32(1) (ii), depreciation under income tax is allowed on the basis of ***WDV method*** and on the basis *of* ***rates prescribed in the act***.
It is not computed on the basis of individual asset rather on the basis of a group of assets called ***Block of Assets*** which means a group of similar type of assets having same rate of depreciation.

b) If any asset is purchased during the year and it has been put to use for less than ***180 days*** during the year, in that case depreciation is allowed at half the normal rate.

But in the subsequent year whenever the asset is put to use, full depreciation shall be allowed irrespective of period of use.

Also, if WDV of the block of asset for calculating depreciation is less than the value of such purchased asset, then depreciation shall be allowed at the half rate on the entire value of the block.

c) ***"Put to use"*** does not mean putting the asset to actual use rather it means making an asset ready for use.

d) On ***sale of any asset***, no depreciation shall be allowed on such asset in that year.

e) Positive ***Balance remaining on sale of all the assets*** of the block is called Short term Loss and the negative balance is called Short term Gain.

f) ***Additional Depreciation***
Additional depreciation shall be allowed at the rate of 20 per cent in case of new plant and machinery which is being used in manufacturing. And if the plant and machinery is put to use for less than 180 days, the rate shall be 10 per cent.

5. Depreciation under Indian GAAP, Ind-AS and ICDS

Recently, the Indian Accounting Standards ("Ind AS") were notified on February 16, 2015 by the Ministry of Corporate Affairs ("MCA"). MCA notified the Companies (Indian Accounting Standards) Rules, 2015 (pending publication in the Gazette of India) which specify the Ind AS applicable to certain class of companies and set out the dates of applicability.

ICDS refers to *Income Computation and Disclosure Standards* issued by the CBDT on March 31, 2015. These standards are applicable for computation of income chargeable under the head "Profit and Gains of business or profession" or "Income from other sources" to all the assessees following the mercantile system of accounting. These standards are applicable for the Assessment year 2016-17.

Some of the key differences between Indian GAAP, Ind AS and ICDS are as follows.

Basis	Indian GAAP (AS-6 and Companies Act, 2013)	Ind AS 16 and IAS 16*	ICDS V
Component wise Depreciation	AS-6 doesn't require assets to be componentized and depreciated separately. But Schedule II of Companies Act, 2013 mandates componentization from Financial years commencing from April 01, 2015. (Also Described above)	Mandates componentization.	Depreciation on tangible fixed assets shall be computed in accordance with the provisions of Income tax Act, 1961 and rules there under.
Residual Value and Useful life	Needs to be reviewed but not compulsorily each year.	Needs to be reviewed annually.	Not covered by ICDS.
Reassessment of depreciation method.	Not specifically stated in Indian GAAP.	Needs to be reviewed annually.	Not covered by ICDS.
Revaluation	No specific requirement on frequency of revaluation.	If an entity adopts the revaluation model, revaluations are required to be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.	Not covered by ICDS. However, under the Act, income / expense recognized only on actual realization.

Methods of Depreciation	Depreciation methods include the straight-line method, the Diminishing balance method and the units of production method. Under India GAAP depreciation shall be calculated on *systematic* basis.	A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. The entity selects the method that most closely reflects the *expected pattern of consumption* of the future economic benefits embodied in the asset.	Not covered by ICDS.
Change in method of depreciation	Requires retrospective re-computation of depreciation and any excess or deficit on such re-computation is required to be adjusted in the period in which such change is affected. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.	Changes in depreciation method are considered as change in accounting estimate in accordance with Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors and applied prospectively.	Not covered by ICDS. However, change in accounting policy can be made only when there is a reasonable cause under ICDS I.

*IAS 16 is an international financial reporting standard (IFRS) adopted by the International Accounting Standards Board.

Author's views

Depreciation is a crucial accounting component of an entity. Any error can affect true and fair determination of the operating results and the depiction of its financial position.

Thorough understanding of depreciation is essential before arriving at accurate conclusions.

Recent changes have made depreciation a much talked about subject. A grip over the changes along with the strong basics is essential for dealing with depreciation.

While applying schedule II, one should account for the transitional provision and record resultant depreciation for the year.

Also, assessment should be made whether the useful life as specified in Schedule II is more indicative for the assets or the company need to do different estimation. And if company use different estimate, it is required to give additional disclosures and justification as duly supported by technical advice.

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