Depreciation under Schedule II – An Overview

MCA vide notification no S.O.902(E) dated 26th March 2014 has notified the provisions of depreciation on fixed assets effective from 1st April 2014 to be governed by Schedule II of the Companies Act, 2013 (‘the Act’) which replaced the erstwhile Schedule XIV of the Companies Act, 1956.

Schedule II defines ‘**Depreciation**’ is the systematic allocation of depreciable amount of an asset over its ‘useful life’ thereby the concept of useful life has been replaced with minimum rates of depreciation prescribed in Schedule XIV in the Companies Act, 1956. The **depreciable amount** is the cost of an asset or other amount substituted for cost, less its residual value (normally it shall not to be more than 5% of the original cost of assets*). The **useful life** of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity. The useful life of an asset shall not ordinarily be different from the useful life specified in Part C of The Schedule II of the Act*. The meaning and concept of useful life in current scenario may have been derived from business dictionary which defined useful life as “*Period during which an asset or property is expected to be usable for the purpose it was acquired. It may or may not correspond with the item's actual physical life or economic life.”*

The definitions of depreciable amount is in same line as stated in Para 16.50 of International Accounting Standard (IAS)-16 “Property, Plant and Equipment” which states ‘*the depreciable amount (cost less residual value) should be allocated on a systematic basis over the asset's useful life*’. Similarly the other provisions of the Schedule II are also in the same line of Indian Accounting Standard (Ind-AS)-16 like Componentization Approach.

Provided that where a company adopts a useful life different from what is specified in Part C or uses a residual value different from the limits specified above, the financial statements shall disclosed such difference and provides justification in this behalf duly supported by technical advice {preferably to be procured from chartered engineer and independent valuer}.
*As amended vide notification dated 29th August 2014

Transition Provisions
Note 7 of the Schedule II states that, 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, **may*** be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil.
*As amended vide notification no. 456 dated 29th August 2014.

Thus from the date this Schedule comes into effect i.e., from 1st April 2014, if the remaining useful life of assets if Nil, then the carrying amount may be charged to retained earnings.

Example 1: ABC Ltd acquired a plant and machinery at a cost of Rs.10000/- on 01.04.2003. The Company is depreciating the plant and machinery (other than continuous processing plant) as per rate specified in Schedule XIV of Companies Act, 1956 i.e. 13.91% (WDV). Now Schedule II of the Act in which useful life for the plant and machinery is specified as 15 years.
Sol: As on 01.04.14, Original Cost is Rs.10000/-, Depreciation up to 31.03.2014 is Rs.8075/-, Carrying Value is Rs.1925/-. The Carrying value as on 01.04.14 will be depreciated over the remaining useful life of the asset as per Schedule II (15-11) 4 years after retaining the residual value of Rs.500/- {5% of Rs.10000/- (original cost of asset)}.

Example 2: Same example as above, except the date of acquisition. Instead of 01.04.2003, the asset has been acquired on 01.04.1997.

Sol: As on 01.04.14, Original Cost is Rs.10000/-, Depreciation up to 31.03.2014 is Rs.9216/-, Carrying Value is Rs.784/-. Here, as per Schedule II, the useful life of asset is only 15 years whereas the asset has already been used for 17 years, therefore the carrying amount Rs.784/- less residual value Rs.500/- = Rs.284/- will be adjusted with opening retained earnings and no depreciation will be charged in the prospective years.

(WDV means Written Down Value, SLM means Straight Line Method)

Accounting Standard

Since no accounting standard has been specifically provided under the Act, Accounting Standard (AS)-6 "Depreciation Accounting" will be considered for *tangible assets*. There are some contradiction between the transition provision under Schedule II and Accounting Standard (AS)-6.

AS-6 provided that in case of deficiency or surplus arising out of retrospective calculation in case of change in method, the amount should be adjusted in the accounts in the *year* in which the change in method takes place, whereas on the other hand Schedule II provides that the carrying amount of assets shall be depreciated over the remaining useful life of asset.

AS-6 provided that in case of deficiency arising out of calculation in case of change in method, the deficiency should be charged in the Statement of Profit or Loss Account, whereas on the other hand Schedule II provides that where useful life of asset is Nil, the carrying amount after retaining residual value to be adjusted with opening balance of retained earnings.

Since, it is stated in the preface of the Accounting Standard issued by The Institute of Chartered Accountants of India (ICAI), if a particular standard is not in conformity with the law, the provisions of the said law will prevail over accounting standard. Considering this, it can be well said that Schedule II will prevail over AS-6 and the transitional provision will be given affect accordingly.

Since no separate rate or accounting standard has been prescribed for amortization of intangible assets under the Act, the Accounting Standard (AS)-26 "Intangible Assets" as issued by ICAI will be considered for calculation of amortization amount of intangible assets.

Method of charging depreciation

The following information shall also be disclosed in the accounts, namely:—

i) depreciation methods used; and

ii) the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule II.

SLM= (Capitalised Cost-Estimated Residual Value)/Estimated Useful Life

WDV= to determine the rate of depreciation, use below formula-

$$A=C(1- \; r/100)n$$

A= Residual Value, C= Value of assets before residual value,r=Rate of Depreciation, n= Useful Life

(WDV means Written Down Value, SLM means Straight Line Method)

The method of depreciation should be in uniformity with the earlier financial years and in case of change in method the same should be accounted for appropriately and need to be disclosed in the financial statement.

Other Points

* Earlier in the Companies Act, 1956 assets which are costing less than Rs.5000/- can be depreciated in the year in which it is procured, but in the present Act there is no such provision. The same should be accounted for in the same manner like other assets above Rs.5000/-.

* Componentization : Schedule II mandate that if the cost of assets is significant to the total cost of the assets and useful life of the said asset is different to that of the original asset, then the useful life of that significant part of asset to be determined separately. As per the recent amended vide notification no. 456 dated 29th August 2014, component approach is voluntary for the financial year 2014-15 and mandatory for period commencing on or after 1st April 2015. However, it would be advisable to indentify each and every asset and its significant part in the financial year 2014-15 itself and that can be possible only if the fixed assets register is thoroughly checked and scrutinized.

* Shift based depreciation: The useful lives of assets working on shift basis have been specified in the Schedule based on their single shift working. Except for assets in respect of which no extra shift depreciation is permitted (indicated by No Extra Shift Depreciation (NESD) in Part C above), if an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period

* Pro-rata approach: The depreciation has to be calculated for the number of days the asset is in use. This is similar to the earlier way of working as done in Companies Act, 1956. Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a pro rata basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed.

* The impact of switch over from rate based calculation of depreciation under Companies Act, 1956 to useful life concept under Schedule II in the new Act need to be identified. Since financial year 2014-15 is the transitional year, the same need to properly considered and disclosed in the notes to financial statement. The impact of depreciation amount can have a significant effect on net profit, calculation of minimum alternate tax or on managerial remuneration which are percentage to net profit.

*` Unit of Production (UOP): The useful life of an asset may be the number of production units expected to be obtained from the asset. This means that the Companies may now use UOP method for depreciation which was restricted under Companies Act, 1956

Example: XYZ Ltd. is engaged in the manufacturing of bottles. For the manufactures of the bottles it uses moulds, so 1.04. 2014, 4 moulds were imported from Spain at a cost of Rs. 1,50,00,000 each. Each mould produces 1,50,000 bottles per year and it is expected to produce 15,00,000 bottles during its life time. The residual value of each mould is Rs. 7, 50, 000. Production for 2014-15 is 1,50,000 units.

Sol:

Useful life of the machine= 15,00,000 units. (Useful life of an asset under Units of Production Method is stated in terms of production output or usage rather than years of service).

Depreciation per unit of production =

$$\frac{1{,}50{,}00{,}000-7{,}50{,}000}{15{,}00{,}000} = 9.5 \text{ per unit.}$$

* Subsidy / Grants received from Government on project and against the assets, the same should be adjusted as was done earlier. The subsidy/grants received are to be adjusted with the same set of assets.

* Revaluation: As stated under Schedule II, the depreciation is provided on historical cost or amount substituted for historical cost. So in case of revaluation of assets, depreciation will be charged on the revalued amount and the amount standing to the credit of revaluation reserve may be transferred directly to general reserve rather than in Statement of Profit and Loss Account.

* Though it is now late to discuss that if a Company has a financial year ending December 2014. Should it revise or calculate the depreciation as per the new Act or does the old Act apply for the Company with "year ended on 31st December 2014". The revised useful life system applies for accounting periods commencing on or after April 1, 2014 and hence the Company may prepare the accounts as per the earlier Act in reference to depreciation as there is a specific mention of the term accounting period, proper disclosure to the same need to be given in the notes to accounts.

* Declaration of Dividend: Section 123 of the Companies Act, 2013 states that "(1) No dividend shall be declared or paid by a company for any financial year except—
(a) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2)…………." and sub-section (2) reads as "For the purposes of clause (a) of sub-section (1), depreciation shall be provided in accordance with the provisions of Schedule II", so a Company has to have provided the depreciation before declaring any dividend.

* Specific Asset: The 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.

* Calculation of Depreciation as per Schedule II (CENVAT adjustment)
XYZ Ltd. had set up its unit in a backward area of Arunachal Pradesh. It had purchased certain plant and machinery for Rs. 75 lakhs. 40% of the cost, net of CENVAT credit is the subsidy component to be realized from Arunachal Pradesh Government for establishing industry in a backward district. Cost Rs. 75 lakhs include excise Rs. 15 lakhs against which CENVAT credit can be claimed. As per management, the plant can run for 8 years with a residual value of Rs. 5 lakhs. It is Company's policy to charge depreciation on WDV method of depreciation.
Computation of depreciation as per New Companies Act, 2013

Particulars	Amount (in lakh)
Purchase Price	75
Less: Excise duty against which CENVAT credit is available	15
Original Cost for accounting purposes	60
Less: Subsidy	24 (60*40%)
Less: Residual Value	5
Depreciable Amount	31

Considering the formula mentioned method of charging depreciation Calculation of revised rates for depreciation:

Depreciation Rate = [5= 36 (1-r)8 => r=21.86% p.a.]

Depreciation for the year 2014-15 will be Rs.7.87 Lakh