P: ISSN NO.: 2394-0344 RNI No.UPBIL/2016/67980 VOL-4* ISSUE-1* (Part-2) April- 2019
E: ISSN NO.: 2455-0817 *Remarking An Analisation*

Emerging Dimensions of Depreciation Accounting (Under the Companies Act, 2013)

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Abstract

Depreciation means decline in the value of an asset due to wear and tear, passage of time or obsolescence. It also includes amortisation of intangible assets as per new provisions of the Companies Act, 2013. Depreciation has a significant effect in determining and presenting the financial position and results of operation of an enterprise.The recent implementation of the Companies Act, 2013 has brought many changes (amendments) as compared to the Companies Act, 1956. One of the key changes is related to useful life of assets contained in Schedule II of the Companies Act, 2013 as against the minimum rates contained in schedule XIV of the Companies Act, 1956. Depreciation on fixed assets are now governed by schedule II of the Companies Act, 2013 which has been made effective from 1st April 2014 vide MCA notification dated March 26, 2014. In case of deviation from the indicative useful life and/ or residual value prescribed in Schedule II, the Companies are required to disclose the reason of deviation with justification duly supported by technical advice. There has been a major change in the useful life of assets of various entities after implementation of new provisions. The change in the useful life of assets particularly Plant and Machinery may have positive/negative impact on the profitability of various entities. Generally it may have negative impact onthe profitability unless they opt for higher useful life of assets after justification. The new approach of calculating depreciation as per schedule II will result in different amount of depreciation charged to profit and loss account, thereby affecting the profits of the entities. This article analyses the different aspects of depreciation provided under the Companies Act, 2013 as compared to the provisions of Companies Act, 1956 along with its impact on profitability of various entities.

Keywords: Depreciation, Useful Life, Companies Act, Schedule, Residual Value.

Introduction

Depreciation means decline in the value of an asset due to wear and tear, passage of time or obsolescence. Accounting Standard-6, issued by the Institute of Chartered Accountants of India (ICAI)defines Depreciation as “measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, passage of time or obsolescence through technology and market-changes. Depreciation is allocated so as to charge a fair proportion of the depreciableamount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is pre-determined.”

Depreciation is charged annually to Profit and Loss Account. Companies Act, 1956 prescribed two methods for calculating depreciation-Straight Line Method (SLM) and Written down Value Method (MDV), whereas the Companies Act, 2013 prescribes Unit of Production Method in addition to SLM & MDV.The Companies Act, 1956 specified minimum rates of Depreciation in Schedule XIV, whereas Companies Act, 2013 specifies useful lives of various Assets in Schedule II as a basis for computation of Depreciation.

Indian Companies Act, 1956 has been replaced by the Companies Act, 2013. The recent implementation of the Companies Act, 2013 is rightly treated as commencement of a new era in Corporate Legislation in India. It has brought many changes (amendments) as compared to the old Companies Act, 1956. One of the key changes is related to useful life of assets contained in Schedule II as against the minimum rates of the depreciation applied so far. Consequently Schedule XIV of the Companies Act, 1956 has been withdrawn and scheduled II of the Companies Act, 2013 is applicable for the purpose of computation of depreciation of assets, with effect from 1st April 2014.

Depreciation has a significant effect in determining and presenting the financial position and results of operation of an enterprise since the amount of depreciation basically depends upon three factors i.e. Cost, Useful life and Net realisable value.

Objective of the Study

The present study has been undertaken with the following objectives:-

1. To analyse schedule II of the Companies Act, 2013
2. To analyse schedule XIV of the Companies Act, 1956
3. To examine the impact of new provisions as per schedule II on the profitability of various entities.
4. To suggest the important measures

Methodology

The analysis of our study is mainly based on data/information collected from secondary sources. To complete our study the information has been collected from various books, journals, magazines, guidance notes and websites.

Hypothesis

Our study is based on the hypothesis that major changes in various provisions of new Companies Act, 2013 will impact on the profitability of various entities caused by change in the amount of depreciation.

Applicability of Schedule II of the Companies Act, 2013

For the purpose of applicability of Schedule II of the Companies Act, 2013, the Companies are divided into three classes as mentioned below:-

Prescribed Class of Companies

In case of Prescribed Class of Companies, financial statements are required to comply with the accounting standard prescribed under the Companies Act, 2013. The useful life of assets of such Companies should also be in accordance with the Schedule II. However, if such a company uses different useful life, it should give a justified disclosure.

Government Companies

In respect of Companies, controlled or regulated by any authority constituted under an Act of Parliament or by Central Government, the useful life or residual value should be taken for accounting purpose notified by such authority.

Other Companies

For other Companies, the useful life and residual value of an asset shall not be higher than prescribed in Part C of Schedule II of the Companies Act, 2013.

Here are some of the assets whose useful lives are given below as prescribed in Part C of Schedule II:-

Nature of Assets	Useful Life
I. Buildings (NESD*)	
a. Buildings (other than factory buildings) RCC Frame Structure	60 Years
b. Buildings (other than factory buildings) other than RCC Frame Structure	30 Years
c. Factory Buildings	30 Years
II. Plant and Machinery (NESD)	
a. Plant and Machinery continuous process for which no special rate has been prescribed	25 years
b. Plant and Machinery: oil and gas (including wells), processing plant and facilities	25Years
c. Plant and Machinery: Hydro Power Generation Plant	40 Years
d. Plant and Machinery used in manufacture of steel	20 Years
e. Plant and Machinery used in manufacture of non-ferrous metals	40 Years
f. Plant and Machinery used in manufacture of pharmaceuticals and chemicals	20 Years
III. Furniture and Fittings (NESD)	
a. General furniture and fittings	10 Years
b. Furniture and fittings used in hotels, restaurants, schools, and other educational institutions, libraries, cinema hall, theatre and circus	8 Years
IV. Motor Vehicles (NESD)	
a. Motor cycles, scooters and other mopeds	10 Years
b. Motor buses, motor lorries, motor cars and motor taxies used in a business of running them on hire	6 Years
V. Computers and Data Processing Units (NESD)	
a. Servers and Network	6 Years
b. End user devices, such as desktops, laptops etc.	3 Years
VI. Aircrafts and helicopters (NESD)	20Years

* NSED= Non Extra Shift Depreciation

Salient Features of Schedule II of the Companies Act, 2013

Useful Life of Asset

The concept of useful life of asset is important in computation of depreciation as per new provisions of the Companies Act, 2013. The useful life of an asset is the period over which an asset is expected to be available for use or the number of production unit 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 Schedule II. When a company adopts useful life of an asset different from the useful life specified in Part C, the financial statement of Company shall disclose such difference with justification duly supported by technical advice. A company has to determine the useful life in the beginning of the year of all fixed assets.

Depreciable Amount and Residual Value

For the purpose of computing depreciation, the new Act defines the term "depreciable amount" as the cost of an asset or other amount substituted for cost, less its residual value(which is normally not to be more than 5% of the original cost of asset.)

If a company uses residual value different from the limit as specified above, the Company will have to disclose such difference with justification duly supported by technical advice. In case of residual value is estimated less than 5% of original cost of the asset then no disclosure is required.

Component Accounting

Schedule II of the Companies Act, 2013 mandates that when the cost of the part of the asset is significant to the total cost of the asset and the useful life of that part is different from the useful life of the original asset, then useful life of that significant part of the asset should be determined separately.

Recently, Ministry of Corporate affairs has notified that the requirement of component approach are voluntary in respect of financial year commencing on or after 1st April 2014 and mandatory in respect of financial year commencing on or after 1st April 2015.

The use of component accounting is likely to cause significant change in the measurement of depreciation and accounting for replacement cost. Thus, a company is required to apply component accounting for all depreciable fixed asset, as it has become mandatory. However, if the carrying amount of any asset is lower than or equal to the estimated residual value of the asset, Companies don't require to apply component accounting for such asset.

Accounting Standard

There is a contradiction between transaction provisions prescribed in the Companies Act, 2013 and provisions of method of depreciation contained in Accounting Standard (AS)- 6 "Depreciation Accounting".

As per AS- 6, the deficiency or surplus arising from retrospective computation of depreciation (in case of change in method) should be adjusted in the accounts in the year in which the method of depreciation is changed but on the other hand Schedule II provides that the carrying amount of assets shall be depreciated over the remaining useful life of the asset.

As per ICAI, if particular accounting standard is not in conformity with the law, the provisions of the said law will prevail over that accounting standard. Thus, we can say that transition provisions given under the Companies Act, 2013 will prevail over accounting standard 6.

Transitional Provisions

Schedule II to the Companies Act, 2013 states that from the date this schedule comes into effect (1st April 2014), the carrying amount of the asset as on that date-

1. shall be depreciated over the remaining useful life of the asset as per this schedule;
2. after retaining the residual value, shall be recognized in the opening balance of retained earningsor may be charged off to profit and loss account where the remaining useful life of an asset is nil.

Extra Shift Depreciation

Schedule II to the Companies Act, 2013 states that the useful lives of assets working on shift basis have been specified in the Schedule based on their single shift working (indicated by NESD in Part C above). If an asset is usedin extra shift for any time during the year, depreciation will be increased by 50% in case of double shift and 100% in case of triple shift for that period. Extra shift depreciation does not apply to continuous process plant (CPP) and the assets have been marked as No Extra Shift Depreciation (NESD) under schedule II.

Depreciation of Low Value Assets

Schedule II of the Companies Act, 2013 does not specify for 100% depreciation for asset whose actual cost does not exceed Rs.5000 as it was provided under Companies Act, 1956.

Disclosure of Financial Statements

The Companies are required to disclose thefollowing information under accounting policies in their annual accounts:-

1. Methods of Depreciation
2. The useful life of assets computing fordepreciation.

In case of deviation from the indicative useful life and/ or residual value prescribed in Schedule II of the Companies Act, 2013, Companies are required to disclose the reason of deviation with justification duly supported by a technical advice.

Provisions on Amortization of Intangible Assets

Amortisation of intangibleassets refers to writing off the cost of intangible assets like Patents, Copyright, goodwill etc., which have utility for a specified period of time.

Depreciation also includes amortization of intangible assets as per Schedule II of the Companies Act, 2013.AS- 38 specifies that the accounting for an intangible asset is based on its useful life.However an intangible asset with an indefinite useful life is not amortised. Thus, we should be careful in determining the useful life of an intangible asset.

As per amendment made by Ministry of Corporate Affairs (MCA), revenue based methodology may be used for amortisation of intangible assets, during the concession period for 'toll road' intangible asset. As per the said schedule, revenue based amortisation is optional not mandatory.

Depreciation of Re-valued Assets

As per Companies Act, 2013, the depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less is residual value. Therefore, in case of revaluation, depreciation will be based on re-valued account. So full depreciation on re-valued amount is expected to be provided.

Unit of Production Method

Schedule II of the Companies Act, 2013 explains that the depreciation of an asset can be provided, (where appropriate) on the basis of units expected to be obtained from the use of the asset. This method of providing depreciation is known as "Unit of Production Method." The method is appropriate, where the number of units can be produced or serviced from the use of assets.For example: Use of aircraft engine is restricted by the number of flying hours, useful life of boilers is limited to the number of hours. The carrying amount of such assets will be depreciated over the revised remaining number of units expected to be obtained or served on prospective basis.

Pro-rata Depreciation

Schedule II prescribes that where any addition has been made to any asset or assets had been sold, discarded, demolished during any financial year, the depreciation of such asset 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 has been sold, discarded, demolished or destroyed. Keeping in view materiality of the amounts involved, pro-rata depreciation is charged in respect of addition and disposal of asset.

Difference between Schedule II and Schedule XIV

New Companies Act, 2013 has provisions related to depreciations contained in schedule II whereas the old Companies Act, 1956 had Schedule XIV containing provisions for the same. Some of the differences between these schedules regarding depreciation are stated below:

Basis for Calculation of Depreciation

Schedule II contains useful life of assets as the basis for calculation of Depreciation whereas schedule XIV contained rates of depreciation of various assets as the basis for calculation of depreciation.

Amortization of Intangible Assets

Schedule II does not only deal the depreciation of tangible assets but also amortization of Intangible assets, whereas Schedule XIV dealt only with the depreciation of tangible assets.

Depreciation on Asset upto Rs.5000/-

Schedule II removed the provision for 100% depreciation on assets whose actual cost does not exceed Rs.5000/-, whereas Schedule XIV provided 100% depreciation for the same.

Extra Shift Depreciation

Schedule II provides the concept of Extra Shift Depreciation (ESD) by providing 50% more depreciation for the asset is used for double shift and 100% more depreciation for the asset is used for triple shift during that period respectively, whereas Schedule XIV also provided that ESD for double and triple shift was to be made separately proportionate to the number of days for which concerned work second shift for triple shift bears to normal number of working days in a year.

Useful Lives

The useful lives specified in Schedule (3) II of various assets will result in their depreciation over different periods. The useful lives of an asset shall not be ordinarily different from the lives of asset specified in Part C of Schedule II, whereas in Schedule XIV (2), the useful life has been reduced as follows, if an entity having straight line method of depreciation.-

1. General Plant and machinery from 21 years to 15 years;
2. General furniture and fittings from 15 years to 10 years;
3. Computers from 6 years to 3 years;

Prescriptive versus Indicative

Schedule II specifies indicative useful life of various assets. Companies can adopt higher or lower life than those specified in the said schedule supported by technical advice, whereas schedule XIV was prescriptive in nature as it specified minimum rate of depreciation as Companies were not allowed to charge lower rate of depreciation than specified in the said schedule. Higher rates were allowed with sufficient technical evidence and disclosure.

Methods of Depreciation

Schedule II specifies threemethods of depreciations i.e. straight line method, written down value method and Unit of Production Method for calculating depreciation,whereas schedule XIV prescribed rate of depreciation under straight line method and written down value method only for different class of assets.

Residual Value

Schedule II specified that the residual value of an asset shall not exceed 5% of its original cost, whereas schedule XIV specified that depreciation shall be calculated on historical cost less residual value. The limit of residual value of an asset was not prescribed for calculating depreciation.

Impact on Profitability of Various Entities

There has been a major change on the useful life of assets of various entities after implementation of new provisions. The change in useful life of assets particularly Plant& Machinery may have positive/negative impact on the profitability of various entities. Generally it may have negative impact on the profitability unless they opt for higher useful life of assets after justification. The new approach of calculating depreciation will result in different amount of depreciation charged to profit and loss account, thereby affecting the profits of the entities. For example, leasing companies may have negative impact on their profits as useful life of Plant & Machinery period has come down in Schedule II. On the contrary, due to increase in the useful life of Plant and Machinery in manufacturing industries, it may have positive impact on its profitability. Similarly, Infrastructure Industries like power, oil and gas may have positive impact on its profitability as they have flexibility in estimating the useful life of assets after proper justification duly supported by technical advice.

Conclusion and Suggestion

On the basis of above study, we found that the Companies are in transitional stage, since they are stepping up towards the new Companies Act, 2013 from the old Companies Act, 1956. The transitional stage has posed many challenges. One of such challenges is posed by Schedule II of the Companies Act, 2013, which is based on the concept of 'useful life'for computation of depreciation instead of minimum rate as per schedule XIV of the Companies Act, 1956.Thus, major changes are required in maintaining books of accounts and accounting policy. For change in the Accounting Policy, the provisions contained in Accounting Standard 5 & 6 both are required to be taken into consideration. We have observed that provisions contained in Schedule II and AS-6 are contradictory to some extent.There is an urgent need to check and scrutinize the asset register and to develop software containing proper mechanism of depreciation accounting of fixed assets to adopt the changes as per schedule II.Companies shouldalso take into consideration the provisions in respect of amortisation of Intangible Assets, Extra Shift Depreciation, Unit of Production Method and Residual Valuefor the computation of depreciation as per new provisions.

Thus, we come to the conclusion that the change in the useful life of assets may have positive/negative impact on the profitability of various entities. Generally, it may have negative impact on profitability unless they opt for higher useful life of assets after justification. In this way, enterprises should have liberty to use straight line method, written down value method or unit of production method as well as to change useful lives of assets comprising proper justification duly supported by technical advice.Forthcoming challenges in the implementation of new Act will be resolved as per new accounting standard, likely to be introduced in the light of new provisions.

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