

GN (A) 35 - Guidance Note on Accounting for Depreciation in companies in the context of Schedule II to the Companies Act, 2013

(This Guidance Note will be applicable for accounting periods beginning on or after April 1, 2016; its earlier application is encouraged.)

1. Definition

Depreciation is systematic allocation of the depreciable amount of an asset over its useful life.

2. Definition

“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.

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 limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice.”

3. Residual Value of an Asset

The residual value of an asset shall not be more than five percent of the original cost of the asset; provided that where a company uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice.

4. Continuous Process Plant (CPP / No Extra Shift Depreciation Asset (NESD)

- “Continuous process plant” means a plant which is required and designed to operate for twenty-four hours a day. The technical design of a CPP is such that there is a requirement to run it continuously for twenty-four hours a day. If it is not so run, there are significant shut-down and/or start-up costs.
- Schedule II indicates useful life of 25 years for CPP, other than those for which special rates have been prescribed in Schedule II.

5. Multiple Shift Depreciation / Asset working in shift basis

- The useful lives of assets working on shift basis have been specified in the Schedule based on their single shift working. 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.”
- The concept of extra shift depreciation applies only to those assets for which the useful life has been estimated on single shift basis at the beginning of the year.
- Where a company, which estimated the useful life of an asset on single shift basis at the beginning of the year, used the asset on double or triple shifts during the year, the depreciation expense should be increased by 50% or 100% as the case may be for that period. Further, for such asset/s, the company at the beginning of the next year should determine whether the asset used in extra shift during the past year was on sporadic (one -off types) basis and is expected to be used on sporadic basis in future also. In such a case, the useful life to be on single shift basis and if in future the asset is used on double or triple shift then as in the past, the depreciation expense for the double or triple shift should be increased by 50% or 100% as the case may be for the period of use. In case the company estimates that the use of the asset for extra shift would not be on sporadic basis i.e. the extra shift working for the asset would be on regular or continuous basis, it should reassess its useful life considering its use on extra shift basis. The reassessed useful life should then be used for the purpose of charging depreciation expense thereafter.

6. Unit of Production (UOP) Method of Depreciation

- The depreciation on an asset can be provided, where appropriate, on the basis of the units expected to be obtained from the use of the asset. This method of providing depreciation is generally known as 'Unit of Production' method (UOP). UOP method is generally considered appropriate where the number of units that can be produced or serviced from the use of the asset is the major limiting factor for the use of the asset rather than the time. Following are some examples where UOP method can be identified appropriate:
 - (i) Useful life of Aircraft engine is restricted by number of flying hours
 - (ii) Useful life of Boiler is limited to number of hours
 - (iii) Useful life of Mould is limited by the number of imprints
- A company will have to review the number of units that can be produced or serviced from the asset in the future periodically. The carrying amount of such an asset will be depreciated over the revised remaining number of units expected to be obtained or serviced on a prospective basis. Where, such an asset is idle for a long period of time, the company should assess whether the use of UOP method is still appropriate.

7. Transition to Schedule II

- 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 recognized in the opening balance of retained earnings where the remaining useful life of an asset is nil."

If the company opts to adjust the carrying amount of the assets to the retained earnings in accordance with the transitional provisions of Schedule II, the tax effect of the same has also to be adjusted directly against the retained earnings in accordance with the

Announcement issued by the Institute of Chartered Accountants of India, "Tax effect of expenses/income adjusted directly against the reserves and / or Securities Premium Account".

8. SLM/WDV method

If a company uses straight line method (SLM) of depreciation, the asset will be depreciated equally over the new remaining useful life of the asset. 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 its remaining useful life using the formula for calculation of rate for depreciation as per WDV method which is reproduced below –

$$R = \{1 - (s/c)^{1/n}\} \times 100 \text{ (Vikram This is to the power)}$$

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

9. Regulatory Rates

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." (Example CERC- Central Electricity Regulatory Commission)

10. Purchase of Used Assets

The useful life of an asset is estimated on the basis of the expectations of the company that purchases (not the seller company) the asset irrespective of whether the asset is a new asset or a used asset.

11. Intangible Assets

- The Ministry of Corporate Affairs (MCA), provides that revenue-based methodology 'may be' used for amortization of intangible assets (Toll Roads) created under 'Build, Operate and Transfer' (BOT), 'Build, Own, Operate and Transfer (BOOT)' or any other form of public private partnership (PPP) route in case of road projects.

The words 'may be' indicates that revenue-based amortization as provided in Schedule II is optional and not mandatory. Moreover, the option is available only for intangible assets arising from toll road projects. Therefore, a company can follow a basis other than revenue-based amortization for intangible assets arising from toll road projects.

- Intangible assets other than those arising from toll-roads should be amortized in accordance with Accounting Standards (AS) 26, *Intangible Assets*, notified under the Companies (Accounting Standards) Rules, 2006.

12. Revaluation of Assets

In case of a revalued asset, the depreciable amount should be the carrying value of the asset after revaluation (revalued amount).

13. Component Approach

- 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." This is commonly known as 'component accounting'.
- Component accounting requires a company to identify and depreciate significant components with different useful lives separately.
- For the purpose of determining the cost of such component, the following criteria can be used in the order given below:
 - a) Break-up cost provided by the vendor;
 - b) Cost break-up given by internal/external technical expert;
 - c) Fair values of various components; or
 - d) Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset

14. Depreciation on Low Value Items

Schedule II does not prescribe any such requirement to provide depreciation at the rate of hundred percent. However a company may have a policy to fully depreciate assets upto certain threshold limits considering materiality aspect in the year of acquisition

15. Pro-rata Depreciation

"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 company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved.

16. Adoption of different methods for similar assets at different geographical locations

- selection of a method of depreciation is a matter of judgment by the management considering various factors, such as, type of asset, the nature of the use of such asset and circumstances prevailing in the business, to allocate the depreciable amount of an asset over its useful life so that the depreciation method best reflects the way the asset is consumed, i.e., depreciation should be allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset .
- Different methods for similar assets at different geographical locations can only be used if the said methods are selected based on the factors discussed above. Otherwise, the use of different methods for similar assets at different geographical locations is not justified.

17. Disclosures

Apart from the disclosures required under the accounting standards, Schedule II requires disclosure of useful life and/or residual value, if they are different from those specified under that Schedule. In this regard, following disclosures should be made:

- i. Disclosure of assets along with their useful lives where different from those specified under Schedule II including where the useful life estimated as per double/triple shift is different from that as would be estimated on the basis of increase in depreciation by 50% or 100% in case of double shift and triple shift respectively of single shift based depreciation.
- ii. The fact that the said useful lives/residual values are supported by technical advice.

Illustration 1

Facts: A Limited is a company incorporated under the Companies Act, 1956, engaged in the business of manufacturing of toys. A Limited purchased a unit of machinery costing ₹60 lakhs as on April 01, 2014. As per Schedule II the general useful life of the assets is 15 years. However, as per A Ltd.'s estimation, the useful life of the asset is 20 years supported by the technical advice.

Issue: Should the company use the useful life as 15 years or 20 years?

Solution:

In this case, keeping in view the requirements under Schedule II, A Ltd. should depreciate the machinery over its useful life of 20 years as determined by the company and not over 15 years as indicated in Schedule II. A limited should also provide disclosures in this regard as recommended later in this Guidance Note in the notes to accounts to justify the reason for difference between the indicative use life and A's estimated useful life.

Illustration 2

Facts: B Limited had considered the minimum rates of depreciation mentioned in Schedule XIV for depreciating all its fixed assets till March 31, 2014. Based on the rates mentioned for SLM and WDV in Schedule XIV, B Limited had derived the useful lives for the assets. Schedule II of the Companies Act, 2013 is now applicable to B Limited w.e.f. April 1, 2014.

Issue: Whether B Limited needs to follow the useful lives mentioned in the Schedule II or derived useful lives considered till March 31, 2013 can be considered?

Solution:

W.e.f. April 1, 2014, B limited should estimate the remaining useful lives of its assets based on the definition of useful life in Schedule II and the factors specified in AS 10 for recognising depreciation in the statement of profit and loss. There is no relevance of the derived useful life as per Schedule XIV. However, if B Ltd estimates useful lives different from those specified in Schedule II, it should disclose such differences in the financial statements and provide justification in this behalf duly supported by technical advice.

Illustration 3:

Facts: B Limited has followed Schedule XIV rates for depreciation of a plant and machinery under WDV method by following the rate of 13.91% as it runs under single shift. The WDV of the asset as at March 31, 2014 is ₹ 23,63,919 and remaining useful life as estimated by the company is 11 years. B Ltd. estimates that the residual value of the asset is 5% of the original cost of the asset, i.e., ₹2,50,000.

Issue: On transition to Schedule II, how plant and machinery should be depreciated?

Solution:

As per the transitional provisions given under Schedule II assets are required to be depreciated over their remaining useful lives. In the above case, since B Ltd follows WDV method for depreciation, the carrying value of ₹23,63,919 of plant and machinery should be depreciated by following the WDV method over its remaining useful life of 11 years. B Ltd. should determine the rate of depreciation to be charged under WDV method as follows:

Rate of Depreciation: $\{1 - (\text{Residual Value}/\text{Cost of the Asset})^{1/\text{useful life}}\} * 100$

Rate of Depreciation in the above case= $\{1 - (2,50,000/23,63,919)^{1/11}\} * 100$

=18.47 %

Year	Carrying Value	Dep. For the year	WDV
1	2,363,919.00	436,690.25	1,927,228.75
2	1,927,228.75	356,019.82	1,571,208.93
3	1,571,208.93	290,251.75	1,280,957.19
4	1,280,957.19	236,633.11	1,044,324.07
5	1,044,324.07	192,919.53	851,404.54
6	851,404.54	157,281.22	694,123.32
7	694,123.32	128,226.43	565,896.90
8	565,896.90	104,538.97	461,357.93
9	461,357.93	85,227.33	376,130.59
10	376,130.59	69,483.16	306,647.43
11	306,647.43	56,647.43	250,000.00

Illustration 4:

Facts: B Limited purchased a unit of plant and machinery on April 1, 2005, and depreciated the same at the rate of 4.75% on straight line basis as per the depreciation rate given in Schedule XIV (equivalent useful life approximately 21 years), even though the useful life as estimated by the management at the time of initial recognition of the asset was higher (30 years). For the financial year beginning on April 1, 2014, when B Ltd. applies Schedule II it estimates that the remaining useful life of the plant and machinery as on April 1, 2014, is 18 years, which is different from the useful life remaining as per Schedule XIV i.e., 12 years.

Issue: Which remaining useful life of plant and machinery should be considered by the B Ltd. to provide depreciation?

Solution:

B Ltd. should depreciate the plant and machinery over its estimated remaining useful life of 18 years on prospective basis and not on the basis of remaining useful life as per Schedule XIV, i.e., 12 years (21 years – 9 years).

Illustration 5

Facts: B Limited purchased machinery as on April 1, 2005 and depreciated the same on straight line method as per the depreciation rates given in Schedule XIV. For the financial year beginning on April 1, 2014, when B Limited applies Schedule II, it estimates that the remaining useful life of machinery is nil and requires to be disposed off.

Issue: What should be the treatment of carrying amount of machinery?

Solution:

The carrying amount of machinery (net of tax) may be recognized in the opening balance of the retained earnings as on April 01, 2014.

Illustration 6:

Facts: B Limited, a company incorporated under the Companies Act, acquired a second hand machinery for ₹5,00,000 from C Ltd. As per the estimate of the C Ltd., the useful life of the asset when it was newly purchased by it was 15 years out of which 8 years have already elapsed (duration for which machinery is used by the C Ltd.). B Limited, for the purpose of providing depreciation on SLM basis under Schedule II, estimates that the asset can be used for 10 years and the residual value is estimated to be nil.

Issue: What useful life of such second hand machinery should be considered by the B Ltd. for providing depreciation?

Solution:

In this case, B Limited should provide for depreciation on the machinery on the basis of useful life of 10 years and not 7 years remaining as per the earlier estimate of C Ltd. (15 years – 8 years). Therefore, depreciation expense to be recognized in the statement of profit and loss for the year would be ₹50,000 (5,00,000/ 10 yrs.).

Illustration 7:

Facts: B Limited is a company engaged in various projects of infrastructure development. B's basic business model is to enter into various infrastructure development projects with the Central and State Governments controlled enterprises under Public Private Partnership Model (PPP). During the year 2011-12, B Limited entered into a contract with the State Government of Haryana for developing a coal-fired thermal power plant serving the states of Haryana, Delhi, Rajasthan and Punjab.

Issue: At the year-end, i.e., 31st March, 2015, for providing amortization on the intangible assets arising from the abovementioned projects for developing thermal power plant, B Limited was of the view that the revenue-based amortization methodology as permitted by the Schedule II may be applied. Whether the view taken by B Ltd. is appropriate?

Solution:

In this case, use of revenue-based amortization is inappropriate as Schedule II permits revenue based amortization only for intangible assets arising from toll road projects and not from any other infrastructure projects even though they are entered into through PPP model, BOT or BOOT.

Illustration 8:

For intangible assets, the provisions of the accounting standards applicable for the time being in force shall apply, except in case of intangible assets (Toll Roads) created under Build, Operate and Transfer', 'Build, Own, Operate and Transfer' or any other form of public private partnership route in case of road projects. Amortization in such cases may be done as follows: -

Mode of amortization

$$\text{Amortization Rate} = \frac{\text{Amortization Amount}}{\text{Cost of Intangible Assets (A)}} \times 100$$

$$\text{Amortization Amount} = \text{Cost of Intangible Assets (A)} \times \frac{\text{Actual Revenue for the year (B)}}{\text{Projected Revenue from Intangible Asset (till the end of the concession period) (C)}}$$

Example:-

Cost of creation of Intangible Assets	:	₹500 Crores
Total period of Agreement	:	20 Years
Time used for creation of intangible Assets	:	2 Years
Intangible Assets to be amortized in	:	18 Years

Assuming that the Total revenue to be generated out of Intangible Assets over the period would be ₹600 Crores, in the following manner:-

Year No.	Revenue (In ₹ Crores)	Remarks
Year 1	5	Actual
Year 2	7.5	Estimate*
Year 3	10	Estimate*
Year 4	12.5	Estimate*
Year 5	17.5	Estimate*
Year 6	20	Estimate*
Year 7	23	Estimate*
Year 8	27	Estimate*
Year 9	31	Estimate*
Year 10	34	Estimate*
Year 11	38	Estimate*
Year 12	41	Estimate*
Year 13	46	Estimate*
Year 14	50	Estimate*
Year 15	53	Estimate*
Year 16	57	Estimate*
Year 17	60	Estimate*
Year 18	67.5	Estimate*
Total	600	

*' will be actual at the end of financial year

Based on this the charge for first year would be ₹4.16 Crore (approximately) (i.e. ₹5/ ₹600 × ₹500 Crores) which would be charged to profit and loss and 0.83% (i.e. ₹4.16 Crore/ ₹500 Crore×100) is the amortization rate for the first year.