GN (A) 35

Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013

The Institute of Chartered Accountants of India

(Set up by an Act of the Parliament)

New Delhi

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Foreword

Accounting for depreciation is generally a significant matter for the purpose of true and fair determination of the operating results of a company as reflected in its statement of profit and loss as well as its financial position as depicted in its balance sheet. Though Accounting Standard (AS) 6, *Depreciation Accounting* has already been issued by the Institute, in the case of companies, some issues have arisen due to the practical application of Schedule II to the Companies Act, 2013, in the context of AS 6.

With a view to provide an authoritative position of the Council of the Institute on the issues arising out of Schedule II to the Companies Act, 2013, the Research Committee of the Institute has formulated this Guidance Note on Accounting for Depreciation in companies in the context of Schedule II to the Companies Act, 2013.

The publication is culmination of joint efforts of two sub organs of ICAI - Research Committee and Accounting Standards Board. I would like to compliment their respective Chairman CA. Subodh K. Agrawal, Past President and CA. Sanjeev K. Maheshwari, respective Vice-Chairmen, CA. Sanjiv Kumar Chaudhary, and CA. S. Santhanakrishnan and their all other members. I would also like to compliment other colleagues in the Council who have contributed immensely towards bringing out this publication.

I am confident that this Guidance Note will be immensely useful to the members of the Institute as well as to others concerned.

Kolkata
February 6, 2016

CA. Manoj Fadnis
President

Preface

The Council of the Institute has previously issued various Guidance Notes on the subject of accounting for depreciation, with particular reference to companies, viz., Guidance Note on Accounting for Depreciation in Companies and Guidance Note on Some Important Issues Arising from the Amendments to Schedule XIV to the Companies Act, 1956. However, after the withdrawal of the above Guidance Notes since those were no longer relevant in accordance with the provisions of the Companies Act, 2013, the Research Committee was requested to formulate a Guidance Note to provide guidance on issues arising on practical application of Schedule II to the Companies Act, 2013 for the purpose of providing guidance on accounting for depreciation in companies.

In view of the above, the Research Committee of the Institute, took up the project to formulate a Guidance Note on Accounting for Depreciation in companies in the context of Schedule II to the Companies Act, 2013 to be issued under the authority of the Council of the Institute, with a view to establish uniform accounting principles for accounting of depreciation as per Schedule II to the Companies Act, 2013.

The Guidance Note provides guidance on multiple shift depreciation, revaluation of assets, as well as component approach besides providing guidance on estimation of residual value, depreciation on low value items, pro rata depreciation etc. Few illustrations have also been included with view to provide guidance on application of the principles provided in the Guidance Note.

The draft of this Guidance Note was initially considered by the Accounting Standards Board before the Research Committee took up this project. Accordingly, I place on record my special thanks to CA. Sanjeev K. Maheshwari, Chairman, Accounting Standards Board. I also place on record my thanks to CA. Sanjiv K. Chaudhary, Vice-Chairman, members of the Research Committee and my other esteemed Council colleagues.

We are confident that this endeavour of the Institute will be beneficial to all the members and others concerned.

February 5, 2016	CA. Subodh K. Agrawal
Kolkata	Chairman, Research Committee

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Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013

Background

1. Schedule II to the Companies Act, 2013, specifies useful lives for the purpose of computation of depreciation. The said Schedule II was further amended by the Ministry of Corporate Affairs (MCA) through its notifications G.S.R. 237(E) dated March 31, 2014 and G.S.R. 627(E) dated August 29, 2014, respectively. As compared to Schedule XIV to the Companies Act, 1956, Schedule II, instead of specifying rates of depreciation for various assets, specifies that depreciation should be provided on the basis of useful life of an asset. While Schedule XIV was prescriptive in nature as it specified the minimum rate of depreciation, Schedule II provides indicative useful lives for various assets. As a consequence, the companies are in a position to charge depreciation based on the useful life of an asset supported by technical advice, even though such lives are higher or lower than those specified in the said schedule. In view of this, depreciation charged as per the useful life is true commercial depreciation bringing the financial statements prepared accordingly closer to those prepared in accordance with international standards.

2. In this Guidance Note wherever the term 'Schedule II' is used it refers to Schedule II to the Companies Act, 2013, and wherever term 'Schedule XIV' is used it refers to Schedule XIV to the Companies Act, 1956, unless specified otherwise.

3. Overview of some of the key changes in Schedule II as compared to Schedule XIV are as follows:

- Useful life 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. Schedule XIV did not include such requirement.

- Schedule II prescribes indicative useful lives of various assets instead of Straight Line Method (SLM)/ Written Down Value (WDV) rates for calculating depreciation.
- Depreciation is systematic allocation of the depreciable amount of an asset over its useful life.
- The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.
- Companies are allowed to follow different useful life/residual value if an appropriate justification is given supported by technical advice.
- Useful lives of significant parts of an asset to be determined separately.
- No separate rate for double/ triple shift; depreciation to be increased based on the double shift/triple shift use of the assets.
- Useful lives of fixed assets prescribed under schedule II to the Act are different from those envisaged under Schedule XIV.
- No reference to depreciation on low value assets.

Objective

4. This Guidance Note is issued with the objective to provide guidance on certain significant issues that may arise from the practical application of Schedule II with a view to establish consistent practice with regard to the accounting for depreciation.

Scope

5. This Guidance Note includes relevant provisions of Schedule II and provides guidance on implementing the requirements of Schedule II.

Shift from Rate-based requirements to Useful Life

6. Paragraph 1 of Part A of Schedule II defines 'useful life' of an asset as:

> "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."

7. Paragraph 3(i) of Part A of Schedule II, as amended, states as follows:

"3. **Without prejudice** to the foregoing provisions of paragraph 1 (of Schedule II),—

(i) The useful life of an asset shall not ordinarily be different from the useful life specified in Part C and 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 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."

8. In view of the above, paragraph 3 of Part A of Schedule II should be read along with paragraph 1 of Part A of Schedule II which defines useful life.

9. It may be noted that paragraph 3 of Schedule II initially provided that the useful life of an asset shall not be longer than the useful life prescribed in Part C. With a view to clarify that the useful lives as prescribed in Part C to Schedule II are indicative, Schedule II was amended by the MCA vide its notification G.S.R. 627(E) dated August 29, 2014, where the expression '**shall not be longer than'** was changed to **'shall not ordinarily be different'.**

10. Under Schedule XIV which specified rates of depreciation rather than useful lives, the Ministry of Industry, Department of Company Affairs, vide its circular No. 1/17/87-CL.V dated March 7, 1989, clarified that the rates as contained in Schedule XIV should be viewed as the **minimum rates**, and,

depreciation at rates lower than those specified in Schedule XIV should not be adopted by the companies. However, on bonafide technical evaluation, higher rate may be applied by a company.

11. Paragraph 13 of Accounting Standard (AS) 6, *Depreciation Accounting,* notified under the Companies (Accounting Standards) Rules, 2006, also contains clarification similar to the aforesaid circular, inter alia, providing that "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." As Schedule II permits useful lives different from that specified in Part C of Schedule II, the useful lives specified therein are indicative only and therefore paragraph 13 of AS 6 now permits useful life longer than that specified in statute.

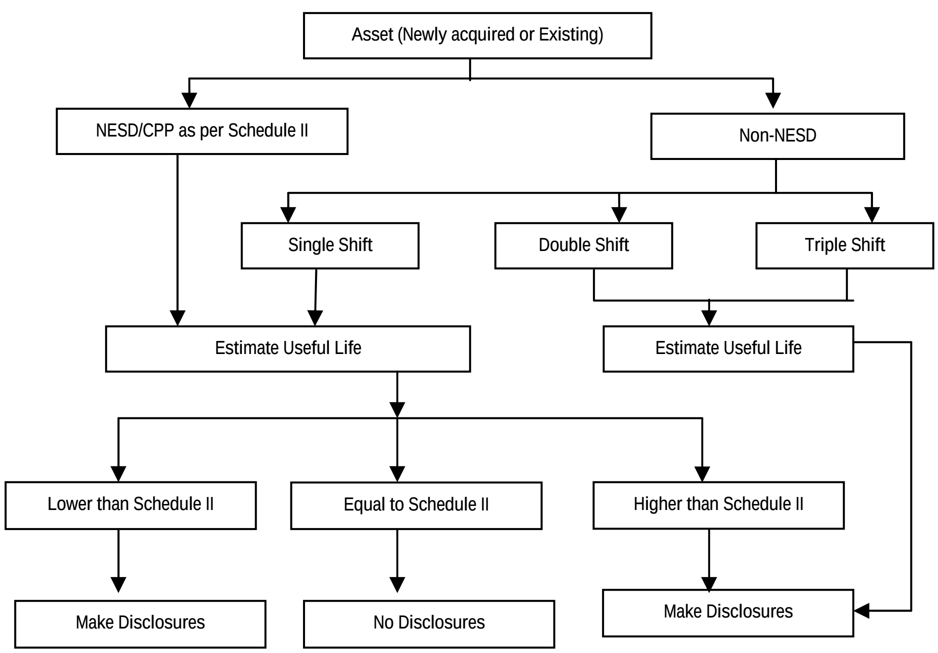
12. Paragraphs 8 and 22 of AS 6 state as follows:

> "8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis."
>
> *"22. The useful life of a depreciable asset should be estimated after considering the following factors:*
>
> *(i) expected physical wear and tear;*
>
> *(ii) obsolescence;*
>
> *(iii) legal or other limits on the use of the asset."*

13. In view of the above, the useful lives as given under Part 'C' of Schedule II for various types of assets are indicative only and are not minimum or maximum. Where the useful lives of various specific assets are the same as those under Schedule II, the company should use these useful lives. In case the useful life of an asset as estimated by the company, supported by the technical advice, external or internal, differs, i.e., higher or lower from the indicative useful life given under Schedule II, the former

should be applied by the company for providing depreciation. The disclosures in this regard should be made as described later in this Guidance Note.The process of determination of useful life is explained in the chart below. A company has to determine the useful life at the beginning of the year for all fixed assets, existing as at the end of the immediately preceding period and for newly acquired assets, as and when acquired . All fixed assets existing at the beginning of the year should be classified into assets for which no extra shift depreciation is applicable which would include continuous process plant (CPP) and assets for which extra shift depreciation applies. Of the assets for which extra shift depreciation applies, assets which are going to be used on single shift, double shift or triple shift are segregated. This segregation is required as the extra shift depreciation is applicable only to those assets whose useful life is determined on single shift basis. After segregation, the remaining useful life of the asset is estimated. A company recognises depreciation expense based on the useful life estimated by the management. Where the useful life estimated by the management is different from that specified by Schedule II, the same is disclosed in notes.

Determination of Useful Life



14. As per paragraph 23 of AS 6, the useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life. Further, paragraph 21 of Accounting Standard (AS) 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies,* notified under the Companies (Accounting Standards) Rules, 2006, provides 'an estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.' Therefore, a company is required to assess whether there have been any changes in the measure of wearing out, consumption or other loss of value of the asset during the year and in future. Where there have been such changes, the company is required to re-estimate the useful life of the asset.

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 Rs. 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?

Response: 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.