

The ICAI provides guidance on provisions relating to depreciation under the Companies Act, 2013

24 April 2015



First Notes on:

Financial Reporting

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Transition:

Immediately

Within the next 3 months
Post 3 months but within 6 months
Post 6 months

Background

On 10 April 2015, the Institute of Chartered Accountants of India (ICAI) has issued an application guide to address certain practical issues arising in the implementation of the Schedule II to the Companies Act, 2013 (2013 Act) relating to depreciation of the assets. The application guide also provides examples for a better understanding of the Schedule II to the 2013 Act. As opposed to the Schedule XIV to the Companies Act, 1956 (1956 Act), Schedule II to the 2013 Act brings along a number of changes in how Indian companies compute depreciation.

This issue of First Notes summarises the key aspects of the application guide issued by the ICAI.

Paradigm shift from rate based approach to useful life approach – tangible assets

Requirements under the 1956 Act

- The accounting standards state that the depreciation amount of a tangible asset has to be systematically allocated over its useful life.
- Additionally, the Schedule XIV to the 1956 Act specified minimum rates of depreciation to be provided by a company.
- If management's estimate of the useful life of a tangible asset as per AS 6, *Depreciation Accounting*, at the time of acquisition of the asset, or the remaining useful life on a subsequent review is shorter than that envisaged in Schedule XIV to the 1956 Act, depreciation was provided at a higher rate.

- Under Schedule XIV to the 1956 Act, residual value of tangible assets could not exceed five per cent of the original cost of the asset.

Requirements under the 2013 Act

- Schedule II to the 2013 Act enshrines within itself the principle for recognising depreciation on the assets over their useful lives and provides as follows:
 - Part C of the Schedule II to the 2013 Act lays down indicative useful lives of certain tangible assets.
 - Useful life of tangible assets should not be ordinarily different from the useful life specified in Part C of the Schedule II to the 2013 Act and the residual value should not be more than five per cent of the original cost of the tangible assets.

- The 2013 Act also permits companies to depreciate assets over their useful lives which may be different from the specified useful lives as per Part C of the Schedule II to the 2013 Act. Where a company adopts a different useful life or uses a different residual value as prescribed in Part C of Schedule II to the 2013 Act, the company is required to disclose such difference and provide justification in the financial statements that is duly supported by a technical advice.

Application guide

- The application guide provides following guidance:
 - Determination of useful life of assets is a matter of judgement and may be decided on a case to case basis. As the 2013 Act permits companies to depreciate assets over their useful lives which may be different from the specified useful lives as per Part C of the Schedule II to the 2013 Act, the companies should involve technical experts to determine the useful life of the assets and maintain adequate details about the technical assessment of the useful lives of the tangible assets.
 - According to AS 6, a company needs to determine useful life/residual value and compare it with the useful life/residual value mentioned in the Schedule II to the 2013 Act. The application guide provides following illustrations:

Situation 1: management of a company has estimated the useful life of an asset to be 10 years while the life envisaged under the Schedule II is 12 years. In this case, the company should depreciate the asset using 10 years and provide a disclosure of justification for using lower life. The company can not use 12 years life for depreciation.

Situation 2: management of a company has estimated the useful life of an asset is 12 years and the life envisaged under the Schedule II is 10 years. In this case, the company has an option to depreciate the asset using either 10 years prescribed in the Schedule II or the estimated useful life i.e. 12 years. If the company depreciates the asset over 12 years, it needs to disclose justification for using higher life. The company should apply the option selected consistently.

The application guide mentions that residual value should also be determined as a corollary to the above situations explained for useful life.

- Determination of the useful life of a depreciable asset is a matter of estimation and would be based on various factors including experience with similar types of assets. Such estimation is expected to be 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. Factors for determining the useful life have been provided in the application guide.

- Useful life of an asset could be shorter than its economic life based on the asset management policy of an entity.
- AS 6 elaborates guidance on determination of residual value and application guide mentions that the possible effects of future price-level changes (i.e. inflation) in estimating residual value should not be considered because anticipated increases in residual value as a result of inflation would represent gain contingencies that should be recognised only when realised.
- Electricity companies should continue to charge depreciation in accordance with the Electricity Act.

Intangible assets

Requirements under the 2013 Act

- The Schedule II to the 2013 Act states that for intangible assets, the provisions of the accounting standards applicable for the time being in force would apply except for amortisation 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) (collectively termed as 'BOT assets') route in case of road projects.

Application guide

- The application guide provides that a company may use revenue based amortisation for 'BOT assets'. For amortisation of other intangible assets, AS 26, *Intangible Assets*, should be applied.

Component approach

Requirements under the 2013 Act

- The Schedule II to the 2013 Act requires that useful life and depreciation for significant components of an asset should be determined separately. However, it is important to note that under AS 10, *Accounting for Fixed Assets*, use of component approach is optional.

Considering the fact that identification of components would require a careful assessment of the facts and circumstances, the Ministry of Corporate Affairs has made the component approach mandatory for financial year commencing on or after 1 April 2015.

Application guide

- The application guide mentions that the determination as to whether a part of an asset is significant, requires a careful assessment of the facts and circumstances. The following factors should be

assessed at the minimum:

- comparison of the cost allocated to the item to the total cost of the aggregated property, plant and equipment, and
- consideration of potential impact of componentisation on the depreciation expense.
- Additionally, the application guide prescribes following factors for determination of cost of a component:
 - Break up cost provided by the vendor,
 - Cost break up given by internal/external technical expert,
 - Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset.

A company needs to identify only material/significant components separately for depreciation.

Identification of significant components is a matter of judgement and decided on case-to-case basis on the facts and circumstances of each case. A company may consider 10 per cent of the original cost of the asset as a threshold to determine whether a component is material/significant. In addition, a company also needs to consider impact on retained earnings, current year profit or loss and future profit or loss to decide materiality. A component that has a material impact from either perspective, the said component would be considered material and require separate identification. Identification of separate parts of an asset and determination of their useful life is not merely an accounting exercise; rather, it involves technical expertise. Hence, it may be necessary to involve technical experts to determine the parts of an asset.

- If the useful life of the component is higher than the useful life of the principal asset, then higher useful life can be used only when the management intends to use the component even after the expiry of useful life of the principal asset.
- The application guide specifically mentions that components should be identified for the opening block of assets existing as at 1 April 2014 (if a company opts to follow component accounting voluntarily) and as at 1 April 2015 mandatorily. The application guide clarifies that component accounting can not be restricted only to new assets acquired on or after adoption of component approach by the company.

Determination of depreciation on assets running on double/triple shift

Requirements under the 2013 Act

- Part C of the Schedule II to the 2013 Act does not prescribe separate rates/lives for extra shift working. Rather, it states that for the period of time, an asset is used in double shift, depreciation will increase by

50 per cent and by 100 per cent in case of triple shift working.

Application guide

- The application guide clarifies that for determining depreciation charge for assets used in double/triple shift operations, the useful life as given in the Schedule II to the 2013 Act is to be treated as based on single shift operations. When an asset is used for double/triple shift operations, the useful life of the asset will not change. In case a company uses its assets for single, double or triple shifts in a financial year, the depreciation charge for number of days operated for double/triple shift has to be increased by 50 per cent/100 per cent respectively.

Depreciation on revalued assets

Requirements under the 1956 Act

- Schedule XIV to the 1956 Act prescribed that depreciation was required to be provided on the original cost. Considering this requirement, the ICAI's Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets (guidance note) permits an amount equivalent to the additional depreciation on account of the upward revaluation of fixed assets to be transferred from the revaluation reserve to the statement of profit and loss.

Requirements under the 2013 Act

- The 2013 Act, on the other hand, requires depreciation to be provided on historical cost or amount substituted for the historical cost. Therefore, companies are required to charge depreciation on the revalued amount to the statement of profit and loss.

It is currently unclear whether the accounting treatment prescribed under the guidance note would continue to remain valid.

Application guide

- The application guide mentions that the accounting treatment given in the guidance note which allows an amount equivalent to the additional depreciation on account of upward revaluation to be recouped from the revaluation reserve *may not apply*.
- AS 10, *Accounting for Fixed Assets*, allows amount standing to the credit of revaluation reserve to be transferred directly to the general reserve on retirement or disposal of revalued asset. The application guide permits transfer of a portion of revaluation reserve to general reserve as the asset is used by the company. In such a case, the amount of the revaluation reserve transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on its original cost.

Full depreciation on assets below certain threshold

Requirements under the 1956 Act

- The provision of Schedule XIV to the 1956 Act allowed 100 per cent depreciation of the cost of an asset having individual value of INR5,000 or less was based on practices followed by the companies based on the materiality of the financial impact of such charge.

Requirements under the 2013 Act

- The above requirement of the 1956 Act has not been carried forward in the Schedule II to the 2013 Act.

Application guide

- The application guide stipulates that life of an asset is a matter of estimation, therefore, materiality of the impact of such charge should be considered with reference to the cost of asset. The size of the company will also be a factor to be considered for such policy.
- Accordingly, a company may have a policy to fully depreciate assets upto certain threshold limits considering materiality aspect in the year of acquisition.

Transitional provisions

Requirements under the 2013 Act

- The transitional provisions under the Schedule II to the 2013 Act prescribes that the carrying amount of

the asset as on 1 April 2014:

- Should be depreciated over the remaining useful life of the asset
- After retaining the residual value, may be recognised in the opening balance of retained earnings or may be charged off to the statement of profit and loss, where the remaining useful life of the asset is nil.

Application guide

- The ICAI announcement on “Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account” requires that any expense charged directly to reserves and/or securities premium account should be net of tax benefits expected to arise from the admissibility of such expenses for tax purposes. Similarly, any income credited directly to a reserve account or a similar account should be net of its tax effect.
- Based on the above announcement the application guide clarifies that if the company opts to adjust the carrying amount of the assets to the retained earnings in accordance with the transitional provisions of the Schedule II to the 2013 Act, the tax effect of the same has to be also adjusted against the retained earnings.

Our comments

- The application guide seeks to address some of the practical challenges that a company may encounter while implementing Schedule II to the 2013 Act. It seems that the ICAI has considered the concerns raised by various stakeholders while preparing the application guide.
- We welcome the clarity provided by the application guide around the rate of depreciation/useful life, residual value and treatment of revalued assets. Further, guidance on component accounting demystifies the misconception around this concept. It is now clear that the objective of component accounting is not to split assets into infinite parts but to split into only material/significant components.
- Few clarifications on certain aspects are still needed:
 - The application guide does not clarify whether technical advice to support the useful lives of assets has to be provided only by an external specialist or an advice from an internal department of a company would also be valid. While some companies may approach specialists to support their estimates; this is an area that could be challenging to implement if companies or auditors are unable (for lack of specific experience or skill) to arrive at or validate these estimates.
 - The application guide allows use of revenue-based amortisation for BOT assets, it is not clear whether revenue-based amortisation can be extended to non-toll road assets.
 - Under Ind AS, companies would be required to use useful lives of the assets for depreciation. It is not clear how the guidance in this application guide will interact with Ind AS.

The bottom line

The issue of application guide is indeed a welcome step as companies are gearing up to prepare the financial statements for the year ended 31 March 2015.

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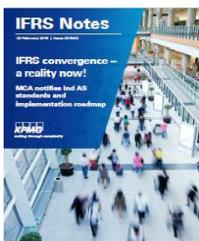
Introducing KPMG in India IFRS Institute



KPMG in India is pleased to re-launch IFRS Institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

IFRS Notes



IFRS convergence – a reality now! MCA notifies Ind AS standards and implementation roadmap

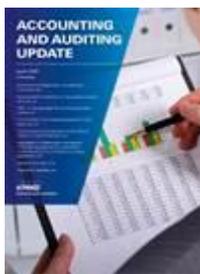
This issue of our IFRS Notes provides a high level analysis of the much awaited Indian Accounting Standards (Ind AS) that are converged with International Financial Reporting Standards (IFRS), which was finally notified by the Ministry of Corporate Affairs on 16 February 2015.

The notification of these IFRS converged standards aims to fill up significant gaps that exist in the current accounting guidance, and India can now claim to have financial reporting standards that are contemporary and virtually on par with leading global standards. This in turn may improve India's place in global rankings on corporate governance and transparency in financial reporting.

With the notification of 39 Ind AS standards together with the implementation roadmap, coupled with the progress made on finalising the Income Computation and Disclosure Standards (ICDS), the government has potentially addressed several hurdles which possibly led to deferment of Ind AS implementation in 2011.

Companies should make an impact assessment and engage with stakeholders, both internal and external, to deal with their respective areas of impact and ensure a smooth transition.

Missed an issue of Accounting and Auditing Update or First Notes?



April 2015

The April 2015 edition of the Accounting and Auditing Update captures the recent issue of the 'Income Computation and Disclosure Standards' (ICDS) by the Ministry of Finance. In this article, we have provided an overview of key matters and our brief comments. This month we discuss the disclosure requirements of the AS 14, Accounting for Amalgamations and the Equity Listing Agreement when a company formulates a scheme of amalgamation.

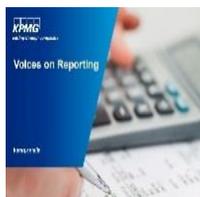
The Institute of Chartered Accountants of India (ICAI) has recently issued a guidance note on fraud reporting. We have provided an overview of this guidance note along with the requirements of the Companies Act, 2013. In addition, we have discussed the requirement of Clause 49 of the Equity Listing Agreement relating to aggregation of the related party transactions. Finally, we also highlight key amendments for the year ending 31 March 2015 introduced under Indian GAAP, IFRS and U.S. GAAP by the respective regulatory bodies in addition to our regular round up of regulatory updates



Updated version of the Companies (Auditor's Report) Order unveiled by the MCA

Section 227(4A) of the Companies Act, 1956 (1956 Act) required that the auditor's report of certain class of companies should include a statement on certain prescribed matters. These reporting requirements were prescribed under the Companies (Auditor's Report) Order, 2003 (CARO – 2003) by the Ministry of Corporate Affairs (MCA). Section 227(4A) of the 1956 Act ceased to be operational from 1 April 2014 after notification of section 143(11) under the Companies Act, 2013 (2013 Act).

Though section 143(11) of the 2013 Act provides requirements similar to section 227(4A) of the 1956 Act, the MCA had not prescribed CARO related requirements. Consequently, after consulting the Institute of Chartered Accountants of India, the MCA on 10 April 2015 issued the Companies (Auditor's Report) Order, 2015 (CARO – 2015) prescribing certain reporting requirements for auditors of certain class of companies. CARO – 2015 will be effective from the date of its publication in the Official Gazette. Our issue of First Notes provides an overview of the CARO – 2015.



KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

On 22 April 2015, we covered following topics :

- (1) an overview of the key changes and implementation challenges for companies that adopt ICDS from this year
- (2) an overview of the financial reporting and regulatory developments introduced under the Indian GAAP during the year ended 31 March 2015.

Feedback/queries can be sent to aaupdate@kpmg.com

Back issues are available to download from: www.kpmg.com/in

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