Schedule II to the Companies Act, 2013

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With the introduction of the revamped Company Law, changes have been brought about in quite a few areas of interest. We're focusing on the changes in depreciation in this article.

Schedule XIV of the erstwhile Companies Act prescribed minimum SLM (straight line method) and WDV (written down value) rates for depreciation. The Companies could charge higher depreciation, if the useful life of an asset was shorter than that envisaged under Schedule XIV.

The Companies Act, 2013 replaces Schedule XIV by Schedule II which requires systematic allocation of the depreciable amount of an asset over its useful life.

Useful Life

Useful life may be considered as a period over which:

- an asset is available for use; or
- as the number of production or similar units expected to be obtained from the asset by the entity; or
- specified time after which the assets are planned to be disposed off; or
- after consumption of a specified proportion of the future economic benefits embodied in the asset.

The useful life of the asset may therefore be shorter than its economic life.

The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets. The useful lives specified in Part C of Schedule II of the 2013 Act for various assets will result in their depreciation over a different period than what is currently applicable under Schedule XIV of the Act.

For example, for an entity using straight line method of depreciation under the Act, useful life has been reduced for

- General plant and machinery from 21 years to 15 years;
- General furniture and fittings from 15 years to 10 years;
- Computers from 6 years to 3 years;

However, in some cases it can also result in lower depreciation — that is, when the useful lives are much longer than earlier rates, as in the case of metal pot line, bauxite crushing and grinding section used in the manufacture of non-ferrous metals and continuous process plants.

In case the companies choose to calculate depreciation on the basis of useful lives which are different from the life specified in the Schedule, the information will have to be disclosed in the financial statements.

What Is The Component Approach?

Schedule II states that the useful life specified is for whole of the asset. However, where a part of the asset is significant to total cost of the asset and the part's useful life is different from the useful life of the remaining asset, the said significant part shall be depreciated separately. This method of breaking a fixed asset into components for depreciation purposes is known as the 'component approach' to compute depreciation. Companies will now have to estimate the useful life of each such component (in case it is not provided in Schedule II) and depreciate the cost of that specific component over the estimated useful life.

How To Apply Component Approach?

To apply the component approach, it is crucial to identify the various significant parts of an asset.

There are two reasons for identifying the parts:

- Depreciation, and
- The replacement of parts.

Generally, it is done by looking for items that will require replacement before the end of the asset's useful life, and to treat these items as separate components.

Upon replacement of a part, the remaining book value of the replaced part is derecognised and the cost of the new part recognised, irrespective of whether the replaced part was depreciated separately or not.

How Many Components?

There is no minimum requirement for the number of parts of a fixed asset that should be identified. The number of parts may vary depending on the nature and the complexity of the fixed asset.

Ind AS 16 requires each significant part of a fixed asset to be depreciated separately. Significant parts which have the same useful life and depreciation method may be depreciated together. Additionally, such parts that are individually not significant are combined in the remainder and are depreciated together.

Identifying the Components

Componentization requires professional judgment. In many situations, a company may not have a good understanding of the cost of the individual components purchased. In that case, the cost of individual components should be estimated based on reference to:

- current market prices (if available),
- discussion with experts in valuation, or
- use of other reasonable approaches.

It might also be considered necessary to request an expert opinion (for example, construction experts) in order to determine the parts of a fixed asset. This will also depend on the size of the organization and whether the component and related depreciation will have a material effect on the financial statements.

For instance, the following practices are commonly used to identify the parts of a building:

- Exterior walls
- Interior walls
- Windows
- Roof
- Staircase

- Elevators
- Air condition
- Heating system
- Water system
- Electrical system
- Major inspections

The following can also help in identifying components:

- Review plant maintenance programs. If the replacement of a component is significant enough to be listed on maintenance schedule, it may have a cost that is significant in comparison to the total cost of the asset;
- Review historical retirement patterns to evaluate what constitutes a component;
- Analyze major capital expenditures.

Capitalization of Expenses

Ind AS 16 states that an entity will recognise costs of day-to-day servicing, primarily towards labour, consumables and small parts, in the Statement of Profit and Loss as incurred rather than in the carrying amount of an item of fixed asset. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the fixed asset, hence they are not being capitalized.

At times, fixed assets (for example, an aircraft) require major inspections for continued operations regardless of whether parts are being replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the fixed asset as a replacement. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

Additions During The Year

Companies seldom purchase assets on the first day of a fiscal period or dispose them on the last day of a fiscal period. Depreciation in such cases will be required to be calculated for partial periods. In computing depreciation for partial periods, companies must determine the depreciation expense for the full year and then prorate this depreciation expense for the period of use. This process should continue throughout the useful life of the asset.

Assume, for example, that ABC Ltd. purchases a machine with a five-year life for Rs. 45,000 (no residual value) on June 10, 20XX. The company's fiscal year ends 31st March. ABC Ltd. therefore charges depreciation for only $9\,{}^{2}/_{3}$ months during that year. The total depreciation for a full year (assuming straight line depreciation) is Rs. 9,000 (Rs. 45,000/5). The depreciation for the first partial year is therefore:

$$\frac{9\,{}^{2}/_{3}}{12} * 9000 = 7250$$

IFRS supplements explain that companies can modify the process of calculating depreciation to a partial period to handle acquisitions and disposals of plant assets more simply.

- Take no depreciation in the year of acquisition and a full year's depreciation in the year of disposal, or
- Charge one-half year's depreciation both in the year of acquisition and in the year of disposal (referred to as the half-year convention), or
- Charge a full year in the year of acquisition and none in the year of disposal.

Companies may adopt any one of these several fractional-year policies for depreciating a fixed asset so long as it applies the method consistently.

To illustrate the accounting for component depreciation, assume that XYZ Airlines purchases an airplane for Rs. 8,00,00,00,000 on 1st April, 20XX. The airplane has a useful life of 20 years and a nil residual value. XYZ uses the straight-line method of depreciation for all its airplanes. XYZ identifies the following components, amounts, and useful lives, as shown below:

Component	Component Amt	Useful Life
Airframe	₹ 48000,00,000	20
Engine	₹ 25600,00,000	8
Others	₹ 6400,00,000	5
	₹ 80000,00,000	

Component	Component Amt	Useful Life	Depreciation
Airframe	₹ 48000,00,000	20	₹ 2400,00,000
Engine	₹ 25600,00,000	8	₹ 3200,00,000
Others	₹ 6400,00,000	5	₹ 1280,00,000
	₹ 80000,00,000		**₹ 6880,00,000**

As indicated, XYZ Airlines records depreciation expense of Rs. 68,80,00,000 in 20XX.

Method of Depreciation

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. The depreciable amount of an asset can be allocated on a systematic basis over its useful life through:

- straight-line method, or
- the diminishing balance method, or
- the units of production method.

That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

Double and Triple Shifts

The useful lives of assets have been specified in the Schedule based on their single shift working. In respect of assets working the second and third shift, Schedule II states that except for assets in respect of which no extra shift depreciation is permitted, 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.

Transitional Provisions

The transitional provision, which requires depreciating the remaining carrying value over the remaining useful life (as determined under Schedule II), can provide harsh outcomes. For example, suppose the remaining carrying value is 60 per cent of the original cost, while the remaining useful life under Schedule II is one year. Here, the entire 60 per cent will be depreciated in one year. However, if the remaining useful life was nil, the entire 60 per cent would be charged to retained earnings.

No Monetary Limits

Under Schedule XIV, assets whose actual cost does not exceed Rs 5,000 are depreciated at 100 per cent. Under Schedule II, there is no requirement to charge 100 per cent depreciation on assets whose actual cost does not exceed Rs 5,000. These assets will be depreciated in accordance with their useful lives.

In effect, componentization may or may not bring about an additional depreciation charge in the Statement of Profit and Loss, depending on the nature and value of fixed assets owned by the Company. As proposed in the Budget 2014, Ind AS, which supports component accounting, will also come into effect from 1st April, 2015. All in all, Schedule II to the Companies Act, 2013 is another step forward by corporate India towards globalizing not only our operations but also our financials.

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