Companies Act, 2013

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Schedule II

Schedule II of the Act has also come into force from 1st April, 2014 vide notification issued by the Ministry of Corporate Affairs dated 26th March, 2014.

The Schedule is divided into three parts: -

- **Part A – Depreciable amount, Useful life, residual value, intangible assets, etc.**

Paragraph 1 of Part A lays down that *"depreciation is the systematic allocation of the depreciable amount of an asset over its useful life".*

There are a few terms in Paragraph 1 which need to be understood here:

➢ **Systemic Allocation**

This term is nowhere defined in the Act or AS 6 – Depreciation Accounting. The word "allocation" has been defined as "apportionment" or "allotment" or "an allowance made upon an account" in the Chamber's dictionary. The word "systematic" has been defined as "according to system" or "methodical" in the Chamber's dictionary.

Thus, clubbing the dictionary meanings of the two words, one can say that the term systematic allocation means "methodical apportionment" of something.

➢ **Depreciable amount**

Depreciable amount has been explained under Part A as the cost of an asset or other amount substituted for cost, less its residual value.

➢ **Useful Life**

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. Useful Life has to be taken as given under Part C. The useful life of an asset shall not normally be different from the useful life as indicated in Part C, provided that if a company uses a useful life which is different from the useful life indicated therein, it shall disclose the justification for the same.

➢ **Residual Value**

As given under Part C of Schedule II, "*Ordinarily, the residual value of an asset is often insignificant but it should generally be not more than 5% of the original cost of the asset."*

A different residual value can be taken, only if the same is justified by the Company. Such departure has to be disclosed in the accounts as per Note 3 to Part C.

Reproduced below is Note 3 to Part C of Schedule II,

"3. The following information shall also be disclosed in the accounts, namely:—
(i) depreciation methods used; and
(ii) the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule."

Determination of residual value of an asset is normally a difficult matter. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

- **Schedule II does not apply to Intangible Assets**

Part A also mentions that Schedule II does not apply to intangible assets and they will be covered under relevant accounting standards. Thus, intangible assets can be continued to be amortized as per prevailing accounting standards in the same manner as it is being done at present until new accounting standards are prescribed under Section 133 of the Companies Act, 2013.

- **Part B – Useful life or residual value of any specific asset**

  In cases where a Regulatory Authority constituted under an Act of Parliament or the Central Government notifies useful life or residual value of any specific asset for accounting purposes, then for such assets, requirements of Schedule II shall not apply.

- **Part C – Useful lives, part of an asset having significant value, residual value, transitional provisions etc.**

  Para 5 under Part C enlists useful lives for various kinds of assets like buildings, machines, ships, motor cars, furniture etc.

Other Matters

➢ **Assets used for a part of the year**

An asset which has been used for a part of the year has to be depreciated on a pro rata basis. This is similar to the requirement under Section 350 read with Schedule XIV of the Companies Act, 1956.

➢ **Component Accounting**

Each Part of an item of an asset with a cost significant in relation to the total cost of the item shall be depreciated separately. Where cost of the part 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 should be determined separately. This concept or process is called 'componentization' under IFRS.

When at the end of respective useful lives of the component, the components will be replaced, the replacement cost should be capitalized and the existing carrying value, if any, should be decapitalized.

➢ **Extra Shift Depreciation**

Under schedule II of companies Act, 2013, no separate rates/ lives are prescribed for extra shift working. Rather, it states that for the period of time and asset is used in double shift depreciation will increase by 50% and by 100% in case of triple shift working.

Let us assume that the company has purchased one plant and machinery three years prior to the commencement of the Companies Act, 2013. Under Schedule XIV of Companies Act, 1956 single shift, double and triple shift depreciation rates applicable to the assets 4.75%, 7.42% and 10.34% respectively. Under schedule II of Companies Act, 2013 its life is 15 years. For all three years, the company has used the assets on a triple shift basis and therefore, depreciation of 31.02% on its cost over three years. For simplicity, residual value is ignored.

On transition to schedule II of Companies Act, 2013, the asset will have remaining life of 12 years. (I.e. 15 years – 3 years) and the management also estimates that on single shift basis remaining life of the asset is 12 years. Hence, the company will depreciate carrying amount of asset over 12 years on straight line basis.

If the company uses the assets on triple shift basis during any subsequent year, depreciation so computed will increase by 100%. In case of double shift, depreciation will increase by 50%.

➢ **Transitional Effect of Schedule II**

The most important and challenging aspect of Schedule II is the effect to be given in the books of account on the date of transition, i.e. 1st April, 2014.

Reproduced below is Note 7 to Part C of 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, shall be recognized in the opening balance of retained earnings where the remaining useful life of an asset is nil."

There could be two possibilities regarding the assets as on 1st April, 2014 in context of the above note:

1. Asset's remaining useful life as per Schedule II is nil

As per Note 7(b), the carrying amount in respect of assets, whose remaining useful life is NIL, there is an option to charge the carrying amount of asset either to retained earnings or to the Statement of Profit and Loss.

2. Asset's remaining useful life is as per Schedule II is not nil

If one reads Note 7, specifically clause (a), then one has to continue depreciating the balance as on 1st April, 2014 systematically over the remaining useful life after recalculating the rate of depreciation. In that case, no effect of restating the carrying amount will be needed to be given. However, there is another possibility here, discussed later.

- **Whether providing depreciation as per Schedule II amounts to change in method of depreciation**

There were two methods of depreciation given under Schedule XIV of the Companies Act, 1956:

(i) Straight Line Method (SLM)
(ii) Written Down Value Method or Reducing Balance Method (WDV)

Rates of depreciation were different under both these methods. However, the rates were calculated in such a manner that any of these methods would enable a company to write off the asset up to its residual value over the same period of time.

Under Schedule II, depreciation has to be provided on a *systematic basis* over the useful life of the asset.

Also, the definition of "depreciation" under AS – 6 is somewhat similar:

"3.1 Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined."

AS – 6 permits both the methods, WDV as well as SLM.

Thus, both the above methods i.e. SLM & WDV can be said to be "systematic allocation" of depreciable amount over the useful life of the asset.

Thus, what has been proposed under the new Act is only a revision of estimated useful lives of assets, there is no change in method proposed.

In such a situation, when there is change in estimate, Paragraph 23 of AS -6 comes into play:

"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."

Similar principle is laid down under Note 7(a) of Schedule II:

"7. 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;"

Thus, companies will have to recalculate the rates of depreciation under SLM or WDV method, depending on the methods which they use at present, and continue depreciating the carrying amount as on 1st April, 2014 at the re-calculated rates.

Now, we have seen that the new Act has only provided for a change in estimated useful lives of the assets as compared to the old Act i.e. Companies Act, 1956. There is no requirement to change the method of depreciation.

- **Another possibility - Change in method of depreciation**

Another possibility here is for companies which want to change the method of depreciation. Before going to the same, it is important to note that change in the method of depreciation is not permitted frequently, and, generally the method of depreciation is to be applied consistently from period to period as per AS – 6.

Unlike the Companies Act, 1956, which spelt out rates as per SLM and WDV methods, Schedule II lays down the useful lives of assets. Thus, under Companies Act, 1956, generally, one had to follow either SLM or WDV method, which may not be the case under Companies Act, 2013.

Thus, there is a possibility for companies which feel that the present method of depreciation needs to be changed in view of a more systematic allocation method being permissible from FY 2014-15 onwards.

Schedule II doesn't provide any guidance for cases in which there is a change in the method of depreciation. Thus, one has to refer the Accounting Standard for guidance in a situation where there is a change in accounting policy/method.

Reproduced below are Paragraphs 15 and 21 of the standard

"15. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

21. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed."

As mentioned earlier, change in the method of depreciation is not permitted frequently, and, generally the method of depreciation is to be applied consistently from period to period. Change in method of depreciation can be done only if such a change fulfills the criteria given in the above paragraphs of AS – 6. Careful consideration is required on part of the company wanting to change the method of depreciation. Appropriate reasons and justifications for the same should be taken on record and documented. The same needs to be disclosed in the financial statements also.

Conclusion:

The provisions under Schedule II of the Companies Act, 2013 have a lot of impact on all the companies in India. So it is a dire need for all of us to understand these provisions, as it would affect accounting of depreciation of companies. Also, while doing audit, it is to be checked that depreciation charged is as per Schedule II of the Act.