Key updates in 'Depreciation' and discussion on Fixed Assets and Impairment

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Key updates in depreciation and fixed assets

- Key updates impacting depreciation
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- Depreciation - beyond basics
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- Major GAAP differences between IGAAP and Ind AS

Key updates impacting depreciation (1/2)

A Fixed Assets & Depreciation

Useful life approach

- **Shift** from *rate based approach* to *useful life approach*
- Schedule II has prescribed **indicative useful lives** for certain tangible assets
- If useful life or residual value adopted is **different** than that prescribed in Part C of Schedule II, the company shall **disclose such difference** and provide **justification** that is duly supported by technical advice.

Intangible Assets

- Accounting Standards 26 – Intangible assets will continue to apply for calculating the amortisation of Intangible assets, **except** for intangible assets created under 'Build, Operate, Transfer' (BOT) or 'Build, Own, Operate, Transfer' (BOOT) model or any other form of Public Private Partnership (PPP) Route
- BOT Assets may use **revenue based amortisation**.

Component Approach

- Component approach is **mandatory** for financial year commencing on or after 1 April 2015
- Components should be **identified on the transition date.** It cannot be restricted only to new assets acquired on or after adoption of component approach by the company.

Key updates impacting depreciation (2/2)

A Fixed Assets & Depreciation

Double/ Triple Shift

- Does not prescribe separate rates as was done in erstwhile Companies Act, 1956.
- In case of asset used in **double shift**, depreciation will increase by **50%** for that period of time**.**
- In case of asset used in **triple shift**, depreciation will increase by **100%** for that period of time**.**

Depreciation on Revalued Assets

- Depreciation to be provided on the historical cost or amount **substituted** for the historical cost.
- Companies are required to charge depreciation on revalued amount to **statement of Profit and Loss.**
- **No transfer** from revaluation reserve to statement of Profit and Loss.

Threshold to provide full depreciation

- Companies Act, 1956 allowed a material threshold of ₹5,000
- **No such limit in the new Act**.
- **Materiality** of the impact of such charge should be considered with reference to the cost of the asset.
- Size of the company will also be a factor to be considered for such policy.

Key terms - Depreciation

Depreciation is a measure of

- the wearing out, consumption or other loss of value of a depreciable asset arising from;
  - use,
  - efflux of time or
  - obsolescence through technology and market changes.

Questions –

- Is depreciation required to be provided for Idle Assets ?
- Is depreciation required to be provided on Asset held for Disposal ?

Key terms - Depreciable assets

Depreciable assets are assets which;

- are expected to be used during more than one accounting period; and
- have a limited useful life; and
- are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

Questions

- Is Goodwill Required to be depreciation ? (Para 1)

Key terms - Useful life & depreciable amount

Useful life is either

- (i) the period over which a depreciable asset is expected to be used by the enterprise; or
- (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Comment

- Relationship between useful life and depreciable amount.

Depreciation - beyond basics (1/2)

A Fixed Assets & Depreciation

Para No	Topic	Issue
Para 11	Change in Estimate of Useful Life	Whether effect to be given is prospective or retrospective ?
Para 15	Effect of Change in Depreciation Method ?	Retrospective or Prospective
Para 9	Depreciation on any Addition or Extension	• Where integral Part • Where separate identity
Para 10	Residual Value	Whether 5 % to be retained or Nil value is allowed ?
Para 16	Where Historical Cost has Undergone Change ?	Retrospective or Prospective

Depreciation - beyond basics (2/2)

Situation –
(EAO – Vol. XI Page 48)
A payment is made for asset, the title is not transferred , expenditure is made on its improvement, should the expenditure be capitalized, depreciated and disclosed

- Basis
  - Substance over form
  - Intended to be used for production
  - Unclear title to be disclosed

- Conclusion
  - Yes.
  - Capitalized and depreciated and disclose fact of unclear title

EAC Opinions - critical issues (1/2)

A Fixed Assets & Depreciation

Sr. No.	EAO Volume no.	Query Particulars	Remarks
Fixed Assets			
1	VXII	Treatment of Trial Run Expenses during substandard production meant for sale	Page 63
2	XIII	Treatment of Liquidated Damages	Page 49
3	XIV	Treatment of Time Barred Liabilities	Page 95
4	XIV	Treatment of Replacement	Page 75
5	X	Treatment of Building Purchased along with Land	Page 10

EAC Opinions - critical issues (2/2)

A Fixed Assets & Depreciation

Sr. No.	Volume no.	EAC Conclusions	Remarks
Depreciation			
1	Vol. V	Adoption of Different methods of depreciation for different class of assets is permitted	Page 47
2	Vol. VIII	Adoption of different methods of depreciation for some class of assets is permitted (e.g. plants at different locations)	Page 72
3	Vol. XXI	Adoption of different methods of depreciation for same class of assets based on acquisition dates is not permitted.	Page 224

Major GAAP differences – IGAAP & Ind AS

A Fixed Assets & Depreciation

Sr. #	Particulars	Indian GAAP	Ind AS
	Property, Plant and equipment		
1	**Initial Recognition - deferred settlement term**	PPE purchased on deferred settlement terms are not explicitly dealt with in AS 10. Cost of fixed assets include purchase price for deferred payment term unless interest element is specifically identified in the arrangement.	Difference between the purchase price under normal credit terms and the amount paid, is recognized as interest expense over the period of the financing.
2	**Component Accounting**	There is no mandatory requirement for component accounting in accounting standards. Though as per the requirement of Companies Act, 2013, component accounting approach has to be followed with effect from April 1, 2015.	Each major part of an item of property, plant and equipment, the cost of which is significant in relation to the total cost of the item, has to be depreciated separately.

Major GAAP differences – IGAAP & Ind AS

A Fixed Assets & Depreciation

Sr. #	Particulars	Indian GAAP	Ind AS
	Property, Plant and equipment		
3	**Replacement Costs**	Unless the expenditure incurred increases the future benefits from the asset, beyond its original standard of performance, it should be expensed.	Replacement cost is capitalized if it meets the recognition criteria. Carrying amount of items replaced is derecognized.
4	**Revaluations**	Revaluation is permitted and there is no stipulation as to the frequency of revaluation.	Ind AS 16 requires an entity to choose either the cost model or the revaluation model as its accounting policy. If the company adopts the revaluation model, revaluations are required to be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

Major GAAP differences – IGAAP & Ind AS

A Fixed Assets & Depreciation

Sr. #	Particulars	Indian GAAP	Ind AS
	Property, Plant and equipment		
5	**Depreciation**	Schedule II to the Companies Act, 2013 has provided the limits for maximum useful life and residual value for calculating depreciation on fixed asset. A company may use different measures, provided justification for the same is disclosed.	Depreciation is charged over the estimated useful life of the asset. There is no concept of minimum statutory depreciation
6	**Periodic review**	There is no specific requirement as to reassess the depreciation method, residual value and useful life at each balance sheet date.	Depreciation method, residual value and useful life are reassessed at each balance sheet date.

Major GAAP differences – IGAAP & Ind AS

A Fixed Assets & Depreciation

Sr. #	Particulars	Indian GAAP	Ind AS
	Property, Plant and equipment		
7	**Change in method of depreciation**	Considered as change in accounting policy, the effect of which is quantified and disclosed. Requires retrospective calculation of depreciation and adjustment of excess or deficit in the period of change.	Considered as change in accounting estimate and the new method is applied prospectively.
8	**Capitalization of exchange differences**	recognized in the statement of P&L. However, an entity has an option to recognize unrealised exchange differences on translation of certain long-term monetary assets/ liabilities directly in equity or as adjustment to cost of an asset. The amount so accumulated in equity shall be transferred to profit or loss over the period of maturity of such long-term monetary items in an appropriate manner.	All exchange differences arising on translation of foreign currency transactions are generally recognized in profit or loss unless can be regarded as borrowing cost eligible for capitalisation.

Major GAAP differences – IGAAP & Ind AS

A Fixed Assets & Depreciation

Sr. #	Particulars	Indian GAAP	Ind AS
	Property, Plant and equipment		
9	**Decommissioning and Restoration (ARO)**	No specific guidance. (Guidance Note on Accounting for Oil and Gas Activities contains specific information relating to such costs, but limited to the industry)	Cost of an item of PPE includes the initial estimates of the cost of dismantling & removing the item & restoring the site on which it is located, the obligation of which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.
10	**Cash flow hedge**	There is no specific guidance on capitalisation on fair value gains/losses on qualifying cash flow hedge relating to purchase of PPE in foreign currency	Fair value gains and losses on qualifying cash flow hedges relating to purchase of PPE in foreign currency can be capitalised

Major GAAP differences – IGAAP & Ind AS

A Fixed Assets & Depreciation

Sr. #	Particulars	Indian GAAP	Ind AS
	Property, Plant and equipment		
11	**Transfer of Assets from Customers : Recognition of Asset**	**Recognition of asset** No specific guidance	**Recognition of asset** 1. When an entity receives an asset from customer, it should assess whether the transferred item meets the definition of an asset set out in the framework. If yes, then the asset would be recognized as PPE as per Ind AS 16 and measure its cost on initial recognition at its fair value. The entity will recognize the corresponding amount as revenue in accordance with Ind AS 18. 2. When the entity receives cash, it should assess whether the asset to be constructed meets the definition of the asset. If yes, then it is recognized as PPE as per Ind AS 16 and revenue is recognized at the amount of Cash received.

Impairment

- Applicability
- Key terms
- Minimum Points to Assess Indication of impairment
- Impairment assessment
- Key Question
- Impairment Loss
- Bottom-Up, Top-Down Approach
- Summary of Standard
- Major GAAP differences – IGAAP & Ind AS

Applicability

B Impairment

- **All Enterprises**

  Accounting Period Commencing on or After 1-04-2004
  - Listed Entities or in the process of being listed.
  - All other business reporting enterprises whose turnover exceeds 50 Crores

  For all other enterprises Accounting Period Commencing on or After 1-04-2005

- **Covers all Assets, excluding only four items below**
  - Inventory
  - Construction Contracts
  - Financial Assets, including Investments
  - Deferred Tax Assets

- **Question:**

  Does the Accounting Standard in reality exclude any asset from recoverability tests ?

  What is the Impact of recent SME ?

Key terms

Value in Use : present value of estimated future cash flows expected to arise from the continuing use of an asset and its disposal at the end of its useful life

Recoverable Amount : Higher of an asset's net selling price and its value in use.

Cash Generating Unit : smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets

Corporate Assets : Assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.

Active Market : All three conditions exist;
(a) the items traded within the market are homogeneous;
(b) willing buyers and sellers can normally be found at any time; and
(C) prices are available to the public.

<u>Minimum</u> Points to Assess **Indication** of impairment

- **External**
  - Decline in Value of Assets
  - Adverse Changes in Environment; legal, technical, market
  - Increase in Interest Rates
  - Carrying Amount is More than Market Capitalisation
  - Evidence of Obsolescence or physical damage

- **Internal**
  - Cash flow requirements are higher than expected
  - Operating results are worst than expected

Impairment assessment (1/3)

<u>Value in Use – How ?</u>

Projected Cash Flows

X

Discount Rate

Impairment assessment (2/2)

Cash Flow Projections

- Components
  - Inflows from Use of Assets
  - Outflows for continuing use and maintenance of assets
  - Terminal value +/-

- Reasonable and Supportable Assumptions
  - 5 year period unless a longer period can be justified backed by demonstrated experience
  - Extrapolation can be made but not exceeding average growth rate

- **Questions**
  - How the impact of future restructuring of operations taken into account ?
  - How the impact of Future Capital Expenditure taken into account ?
  - What period shall be considered for cash Flow ?

Impairment assessment (3/3)

Discount Rates

- **Starting Point;**
  - WACC or
  - Incremental Borrowing Rate
  - Other Market Borrowing Rate

- **Adjusted**
  - Post-tax to Pretax
  - Country risk
  - Currency risk
  - Price Risk
  - Cash Flow Risks
- **Question:**
  - Is the Discount Rate independent of Enterprise Capital Structure (Para 53) ?

Under What Circumstances

Is impairment testing necessarily required ?

Where required, whether detailed Calculations for Value in USE Can be avoided ?

Impairment Loss : Individual Asset

<u>Impact on Assets</u> : Net of Impairment

<u>Impact on Depreciation</u> : Calculated Prospectively on the revised Amount

<u>Question</u>:

Where Impairment loss is more than carrying amount, whether the excess shall be recognised as liability ?

<u>Treatment of Reversal of Impairment Losses</u>

- Maximum reversal permitted (lower of)
  - Impairment loss originally calculated or
  - Would have been carried amount
- Impact on Depreciation

Allocation of Impairment Loss : CGU

Reallocate as necessary

1. Goodwill

2. Other assets on a pro rata basis based on carrying amount. Allocate to the highest of:

- Net selling price
- Value in use
- Zero

Assets not part of CGU

- **Un-allocated Assets like;**
  - Goodwill
  - Group Brands
  - Corporate Assets

  Were not Part of CGU

- Have these been excluded

  Excluded from Impairment

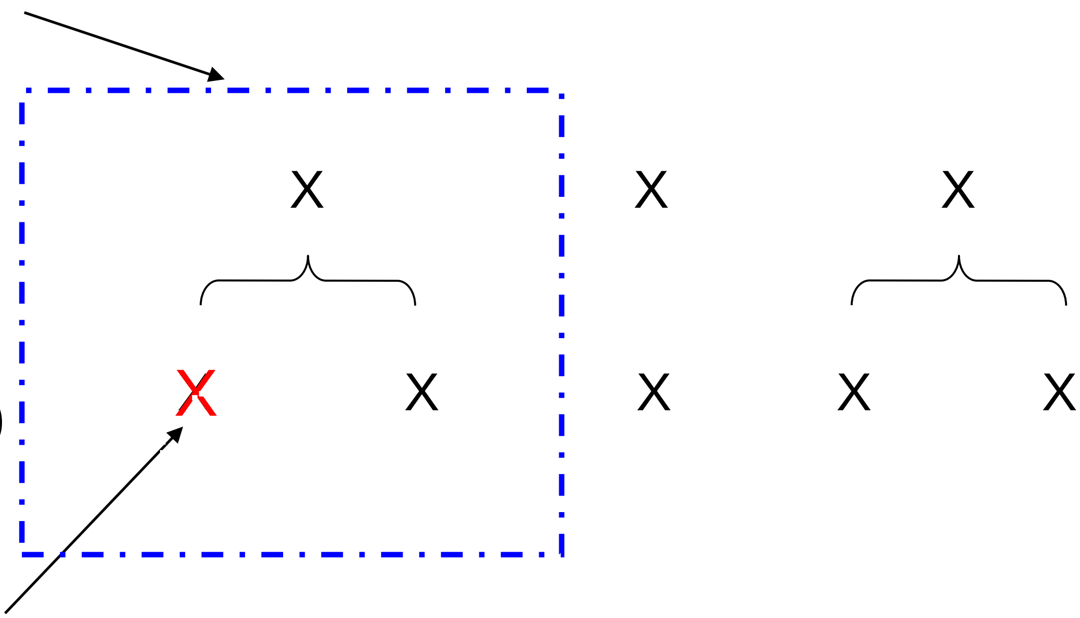
  Testing

Bottom-Up, Top-Down Approach

Top-down test (larger CGU)

Goodwill

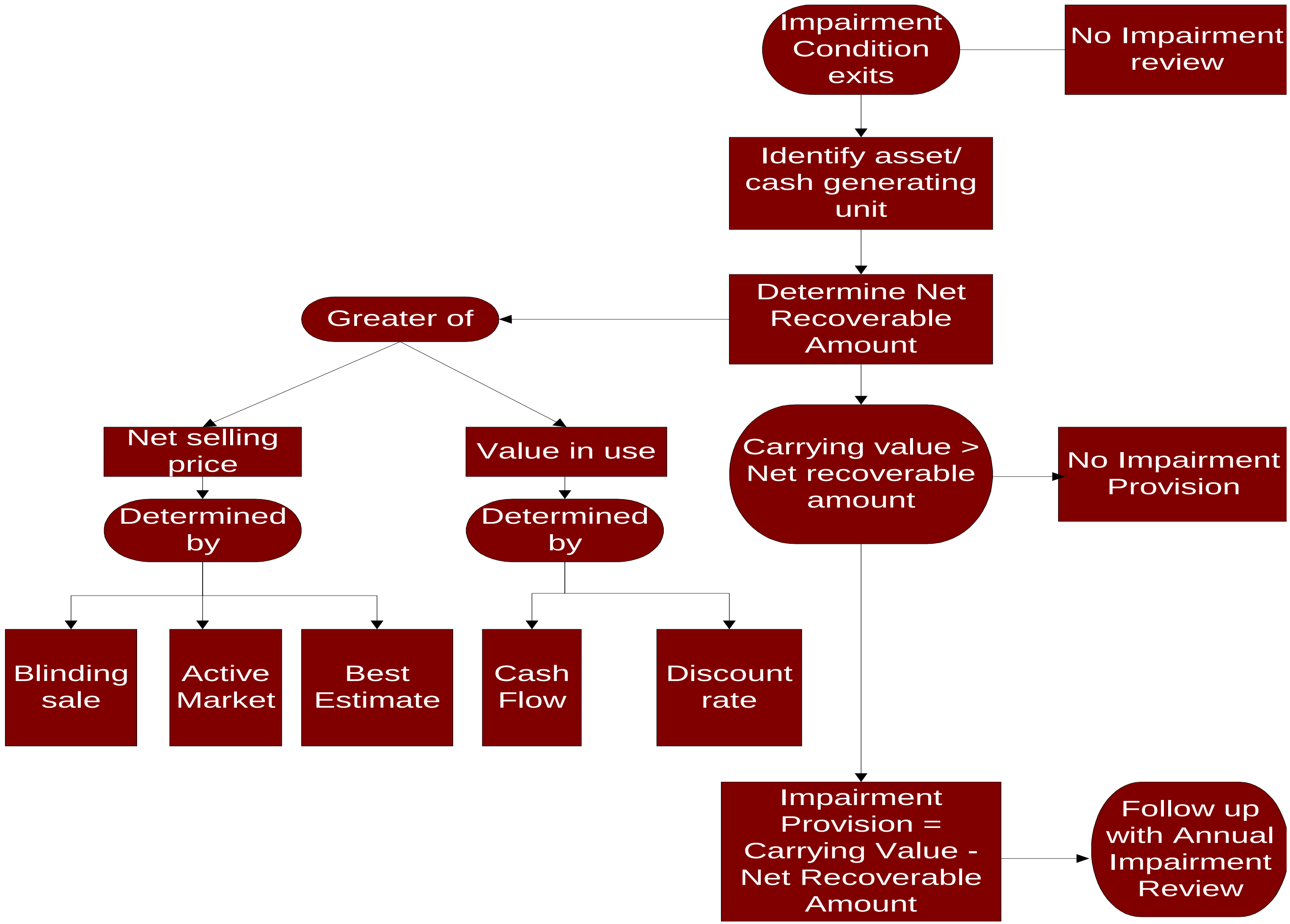
CGU's (PPE, intangibles)



Bottom-up test (smaller CGU)

Summary of Standard

B Impairment



Major GAAP differences – IGAAP & Ind AS

B Impairment

Sr. #	Particulars	Indian GAAP	Ind AS
	Impairment		
1	**Goodwill impairment**	The bottom up/top down approach is adopted whereby, the goodwill is tested for impairment by allocating its carrying amount to each CGU or smallest group of CGUs to which a portion can be allocated on reasonable and consistent basis.	The goodwill is allocated to CGUs that are expected to benefit from the synergies of the business combination. The goodwill is allocated at the lowest level where it is internally monitored by the management, which should not be larger than an operating segment before aggregation of segments as defined in Ind AS 108.
2	**Annual impairment tests for goodwill and intangibles**	Goodwill and other intangibles are tested for impairment only when there is an indication that they may be impaired. AS 26 requires intangible assets that are not available for use and intangible assets that are amortised over a period exceeding 10 years to be assessed for impairment at least at each financial year end even if there is no indication that the assets is impaired.	Goodwill, intangible assets not yet available for use and indefinite life intangible assets are required to be tested for impairment at least on an annual basis or earlier if there is an impairment indication.

Major GAAP differences – IGAAP & Ind AS

B Impairment

Sr. #	Particulars	Indian GAAP	Ind AS
	Impairment		
3	**Reversal of impairment loss for goodwill**	Can be reversed only if the impairment was caused by a specific event of an exceptional nature which is not expected to recur and other subsequent external events have occurred which have reversed the effect of that event.	Reversal of impairment of goodwill in a subsequent period or in a subsequent interim period is prohibited

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