

May 13, 2014

Shri Naved Masood
Secretary
Ministry of Corporate Affairs (MCA)
Room No. 515, "A" Wing,
Shastri Bhawan, Rajendra Prasad Road
New Delhi - 110001

Sir,

**CFI Representation on
'Effects of Higher Depreciation under New Companies Act'**

Construction Federation of India (CFI) is the representative body of leading engineering firms of the country engaged in the construction of critically important infrastructure development projects such as dams, power stations, highways, ports and similar works.

We take this opportunity to submit problems faced by this sector due to the effects of higher depreciation to be provided in the statutory accounts of companies under the new Companies Act, i.e. Companies Act, 2013 along with the consequential effect in Profit & Loss Account and Balance Sheet of Companies with effect from the year 2014 - 2015.

1. The depreciation in the books provided by a Company, so far, has been as per Schedule XIV of the Companies Act, 1956 (Old Act)which was the minimum depreciation to be provided by a company in their Annual Accounts. Accordingly, depreciation on general Plant & Machinery, (except special rate category of Plant & Machinery) was 4.75% on Straight Line Method (SLM) or 13.91% on WDV basis as per Schedule XIV of the Old Act. In other words, the useful life of Plant & Machinery, was generally 20 years after considering residual value of 5% of the original cost of the Plant & Machinery.

....2/-

: 2 :

2. In the Companies Act, 2013, (New Act) in Schedule II, no rates of depreciation has been provided on Plant and Machinery or any other assets. Instead of rate of depreciation “useful life” of all assets including Plant & Machinery has been given. However, from useful life, the rate of depreciation can be worked out. Further, for the purpose of calculating depreciation, plant & machinery has been classified industrywise and accordingly, useful lives of the Plant & Machinery in various industries have been different. In general, it can be said that in most of the cases the useful lives of Plant & Machinery in the new act is much lower than 20 years, which was the rate as per Sch XIV of the old act, and in some cases it is much lower and even in the range of 8 to 10 years . Under the new act even the general Plant & Machinery (which are not covered under specific industries), the useful life has been reduced from earlier 20 year to 15 years (vide item IV (1)(a) of Sch II of the Companies Act 2013).
3. In order to explain the matter, we will consider the case of Construction Companies. In Sch XIV of the old act as indicated above, there was no separate category of Plant & Machinery for construction companies , but in the New Act in Schedule II, Plant & Machinery used by “Civil Construction Companies” has been given in a separate category with “useful life”.
4. As mentioned earlier, the useful life of Plant and Machinery used by a construction company was generally 20 years as per Schedule XIV of the old Act but in Schedule II of the New Act the useful life of Plant and Machinery used by Civil Construction company has been reduced in the range of 9 years to 12 years except one category of Plant and Machinery, i.e. Cranes where the useful life is 15 to 20 years (vide item no. IV(ii) (k) of Part ‘C’ of Schedule II). The useful life of Plant and Machinery used in Civil Construction companies as per Schedule II of the New Act, has been **given in the attached schedule**.
5. From a comparison of depreciation on Plant and Machinery, as per Schedule XIV of the Old Act and Schedule II of the New Act 2013, it will be seen that -
 - i. The useful life of most of the Plant and Machinery used by the Construction Companies has been substantially reduced. As a result, higher charge for depreciation on Plant and Machinery will have to be considered by a construction company in each year. The impact of higher depreciation charge in the Company’s accounts has been explained in detail in the paragraph (ii) below. For simplicity's sake, we are giving the example on Straight Line Method (SLM) of depreciation.

....3/-

: 3 :

ii. There will be a substantial amount of opening adjustment which is explained below :

a. Supposing the Plant and Machinery is a road making equipment whose revised life is now 12 years as per Schedule II of New Act but the said road making machinery has **already worked for 12 years and is still in working condition** in a construction company at present. As per the revised depreciation rules, the balance WDV, after the expiry of 12 years, will have to be written off in the books. To give an example, in the above case, let us assume, the cost of Plant and Machinery is Rs 100/- and in 12 years, depreciation so far provided has been 4.75% on Rs.100/- x 12 years = Rs.57/- and the balance WDV will be Rs.100-57=Rs.43/- and, as per schedule II, of the New Act the residual value can be considered as 5/- , i.e. Rs 43-5=Rs38/- i.e. the balance WDV will have to be written off by a Construction Company by debiting the retained earnings or reserve account (vide note no. 7 of Schedule II of the New Act) in the year of implementation of Schedule II i.e. in 2014 -15.

b. Apart from the above, there is another aspect of the matter. Supposing some Plant and Machineries of the above category **has been working for 7 years**, and in 7 years , depreciation has been provided so far in the books is

$Rs.4.75 \times 7 = Rs.33.25$. Therefore, the balance WDV will be $Rs.100 - (Rs.33.25 + 5) = Rs.61.75$ which will have to be written off in the remaining 5 years ($Rs.61.75/5$), i.e. @ 12.35% per annum. (vide note no. 7 of Schedule II of the New Act .)

6. The construction companies are using these Plant & Machinery over a long period of time and from practical experience it can be said that the useful life of the said Plant & Machinery has been made unrealistically low and that this effect of higher depreciation will consequently affect the net worth of the concerned Company in the first year of the implementation and thereafter in the Profit & Loss account of the Construction Companies in future years also. As a result, the Profit Before Tax (PBT), Profit After Tax (PAT) and Earning Per Share (EPS) as also Net Worth (NW) will all be adversely affected for the Construction Companies not only in the year of implementation but also in subsequent years.

.....4/-

: 4 :

7. This unusually high rate of book depreciation will have another aspect to consider. In case of inadequacy of taxable profit of a company, a minimum alternate tax (MAT) is payable based on book profit of the company (vide Sec 115JB of Income Tax Act). Now with a unrealistically high depreciation charge, the book profit would also be considerably low and as a result MAT will also be reduced considerably. In respect of opening adjustment on account of write off of the balance written down value (WDV) due to expiry of useful life of Plant & Machinery , in the year of implementation of Schedule II of the New Act, (vide 5(ii)(a) of this note) the opening adjustment amount which would be quite substantial will be debited to retained earnings i.e. general reserve.

As per Sec 115JB of the Income Tax Act , any amount debited to reserve, which would have otherwise been debited to profit & loss account, could be considered as a reduction from book profit for the purpose of calculation of MAT . If such be the case, and the assessee claims the higher book depreciation for the purpose of computing the MAT, there may be prolonged litigation with the tax authorities .

8. Very recently, in the last week of March 2014 there has been an amendment in Sch II of the Companies Act 2013 (vide undated notification of MCA with File Number 17/60/2012-CL-V), in which it has been stated that where a company uses a useful life or residual value of the asset which is different from the above limits, (i.e. as specified in Part 'C' of Sch II) justification for the difference shall be disclosed in its financial statement . (vide amended para 3 in Part 'A' to Sch II of the New Act) . Accordingly, it appears that the company may choose to adopt higher/lower useful life if the same can be justified and depreciation rates across companies may vary even within the same industry.
9. The above interpretation is in consonance with Accounting Standard (IND AS) 16 - "Property, Plant and Equipment" which is expected to be implemented by Ministry of Corporate Affairs (MCA) with effect from 1.4.2016 . In the above accounting standard , there is no rate of depreciation on assets but only "useful life" of the assets have been mentioned . Moreover, the life of the assets will be determined by the entity itself which is also subject to periodical review by the said entity.

....5/-

The relevant extract of (IND AS) 16 is given below :

“57 The useful life of an asset is defined in terms of the asset’s expected utility to the entity .

.....
.....
The estimation of the useful life of the asset is a matter of judgment based on the experience of the entity with similar assets .”

It will therefore be seen that there can not be a straight jacket useful life of all the plant & machinery under the same group of Plant and Machinery and moreover in the same industry, the useful life may vary from one company to another company . However, there has been a confusion as to whether useful life of the plant & machinery given in Part C of Sch II of New Act 2013 is indicative in nature or it is mandatory . This confusion has particularly arisen in the context that the depreciation calculated on the basis of the useful life given in Sch II of the New Act whether it is the minimum depreciation to be provided in the books or not.

In view of the difficulties faced by our members as explained above, the Federation earnestly requests you to kindly consider the following suggestions for providing relief:

- i. The useful life of the assets should be kept as far as possible in earlier level i.e. as per Sch XIV of the old act .
- ii. A clarification for MCA will be extremely helpful which will clear the confusion as to whether the useful life as given in Sch II is indicative or mandatory and in that case, companies will be free to proceed further in this regard particularly review of the useful life of the Plant & Machinery by technical experts if necessary.

We also thankful to have an opportunity for explaining our submissions in person to your goodself if so required.

With kind regards,

Yours sincerely,

(Siddharth Singh)
Secretary General

Schedule

Relevant extracts from Schedule II of the Companies Act, 2013

Useful life

IV. Plant and Machinery

(i) (a) Plant and Machinery other than continuous process

Plant not covered under specific industries 15 Years

(ii)(k) Plant and Machinery used in civil construction

1. Concreting, Crushing, Piling Equipments and Road Marking Equipments 12 Years
2. Heavy Lift Equipments -
 - Cranes with capacity of more than 100 tons 20 Years
 - Cranes with capacity of less than 100 tons 15 Years
3. Transmission line, Tunneling Equipments (NESD) 10 Years
4. Earth-moving equipments 9 Years
5. Others including Material Handling / Pipeline / Welding Equipments (NESD) 12 Years

Shri Naved Masood
Secretary
Ministry of Corporate Affairs (MCA)
Room No.515, "A" Wing,
Shastri Bhawan, Rajendra Prasad Road
New Delhi - 110001

Shri Naved Masood

Secretary

Ministry of Corporate Affairs (MCA)

Room No.515, "A" Wing,

Shastri Bhawan, Rajendra Prasad Road

New Delhi - 110001

Tel: 23382324, 23384017

Fax: 23384257

secy.mca@nic.in

Shri V.S.Manian	PSO	23382324 23384017 23384257(fax)	-
-----------------	-----	---------------------------------------	---

Shri Rajendra Kumar	PA	23382324 23384017 23384257(fax)	
---------------------	----	---------------------------------------	--

Letter forwarded to

Shri N K Dua, Dy. Director MCA

Tel: 230711909

narendra.dua@mca.gov.in