

Rates of depreciation on various assets involved in mass rapid transport system.

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A government company has been incorporated to construct and operate a mass rapid transport system (i.e. metro trains) in the National Capital Region. While some phases of the system have already become operational, others are at various stages of construction or conceptualisation. The construction of a mass rapid transport system involves incurrance of huge capital expenditure. Consequently, depreciation constitutes a significant element of cost of operations.
2. According to the querist, three major types of fixed assets, each of which accounts for a substantial capital expenditure and are quite unique to the company in the Indian context are as follows:
 - (a) Rolling stock
 - (b) Escalators and elevators
 - (c) Track work
3. The querist has stated that Schedule XIV to the Companies Act, 1956, does not specifically lay down any rates of depreciation in respect of the above categories of fixed assets. In the absence of a specific rate, if the company applies the general rate applicable to plant and machinery, it would be totally unrepresentative of the useful lives of these assets. According to the querist, this general rate applicable to plant and machinery (i.e., 4.75 percent on straightline basis) assumes that the useful life of general items of plant and machinery is 20 years whereas, the estimated lives of Rolling Stock, Escalators and Elevators, and Trackwork are much longer than 20 years. The special features of these items are as below:
 - (i) Rolling stock: The trains are of modern design and are lightweight made of stainless steel with three phase AC drive having VVVF control regenerative braking and suitable for automatic train protection and operation system. The coaches are provided with automatic door closing mechanism to ensure passenger safety. The coaches have been built, meeting international standards of safety, reliability and maintainability. They are designed and constructed for a service life of at least 30 years of normal usage, without major repair.
 - (ii) Escalators and elevators: They are provided at elevated and underground stations for passenger transportation. These heavy duty public escalators comply with international and national standards. The design, manufacture, supply, installation, testing and commissioning of the escalators meet the state of the technology in the area. The life of these escalators and elevators is estimated at a minimum of 30 years.
 - (iii) Track work: With a view to obtaining optimum life for various components, a sturdy track structure has been selected, such as 60 kg. head hardened rails, ballast-less track on viaduct/tunnel and structurally strong turnouts. A life of 58 years is estimated for the same.
4. As per the querist, the estimates made by the company are based on technical evaluation and suppliers' assertions.

These estimates are prudent and would represent true and fair commercial depreciation. The querist has separately provided technical evaluation reports of suppliers in this regard for the perusal of the Committee. Comparative depreciation rates/lives of assets adopted by the companies carrying similar operations, along with the corresponding lives under the Companies Act, 1956 and that as estimated by the company, are also provided separately by the querist for the perusal of the Committee. According to the querist, a perusal of the comparative analysis of depreciation rates/useful lives highlights the following in respect of the said assets:

- (a) Rolling stock: All the companies carrying similar operations have estimated life of rolling stock much higher (at 35-40 years) than 20 years which is the life worked out on the basis of the general rate applicable to plant and machinery as per the Companies Act, 1956. According to the data given by the management, the suppliers of the company have estimated the life at 30 years. The life of 30 years, according to the querist, therefore, seems a prudent estimate.
 - (b) Escalators and elevators: The useful life has been estimated around 30 years by various other companies (except one company). However, the general rate as prescribed in Schedule XIV to the Companies Act, 1956 envisages a life of 20 years. The life of 30 years as estimated by the management may, therefore, be adopted.
 - (c) Track work: The management's estimate of 58 years is supported by the estimates of other railway companies.
5. The querist has stated that the company applied for concurrence to the aforesaid special rates of depreciation to the Ministry of Urban Development (Administrative Ministry) and the Ministry of Company Affairs. In response, the Ministry of Urban Development, vide its Office Memorandum No. 14011/73/2003/MRTS dated 22.3.2004, communicated its concurrence. The Ministry of Company Affairs vide its letter dated 22.8.2005 asked the company to seek the expert opinion from the Institute of Chartered Accountants of India.
 6. The querist has stated that as per Accounting Standard (AS) 6, 'Depreciation Accounting' issued by the Institute of Chartered Accountants of India, useful life is *"...the period over which a depreciable asset is expected to be used by the enterprise..."* (emphasis supplied by the querist). Further, paragraph 8 of AS 6, inter alia, states that *"determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets"* (emphasis supplied by the querist). The querist has also drawn the attention of the Committee to paragraph 22 of AS 6, which states as follows:

"22. The useful life of a depreciable asset should be estimated after considering the following factors:

 - (i) expected physical wear and tear;***
 - (ii) obsolescence;***
 - (iii) legal or other limits on the use of the asset."***
 7. The querist has further stated that AS 6 also recognises in paragraph 13 that *"the statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under*

the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute." (Emphasis supplied by the querist.) According to the querist, it is clear from the aforementioned provisions that one has to:

- (a) estimate the useful life of the specified categories of fixed assets, and
 - (b) consider the position under the Companies Act, 1956.
8. According to the querist, as far as the estimate of the useful life is concerned, technical estimates and past experience are important indicators. The practice followed by the companies using similar assets is another useful indicator (provided those companies are not covered by any specific legal stipulations). As per the querist, in the present case;
- (a) the technical specifications agreed to between the company and the suppliers of rolling stock, escalators and elevators clearly stipulate a life of a minimum of 30 years;
 - (b) other entities using similar assets are also charging depreciation at rates based on estimates of useful lives which are generally higher than those estimated by the company; and
 - (c) the Ministry of Urban Development has independently concurred with the useful life as envisaged above.
9. On the basis of the above, the querist has argued that there is a strong logic for the Ministry of Company Affairs to specifically allow 'rolling stock' and 'escalators and elevators' of the company being depreciated at 3.17% (SLM) and track work being depreciated at 1.63% (SLM) based on technical life of the relevant assets. Also, since the above estimates already take into account the extent of likely usage of the assets (which will be almost

on a continuous basis round the clock except for a few hours around mid-night), it may also be specifically provided that there would be no extra shift depreciation on those assets.

B. Query

10. The querist has sought the opinion of the Expert Advisory Committee on the following issues:
- (a) Assuming that (i) it can be demonstrated that the useful life of rolling stock and escalators and elevators is 30 years and that of track work is 58 years and (ii) there are no legal stipulations as to rate of depreciation, whether charging depreciation at 3.17% and 1.63% (respectively) per annum as per straight line method (SLM) would result in a true and fair view.
 - (b) Since the company, as per the querist, has been able to adduce sufficient evidence regarding the above estimates of useful life, whether depreciation at 3.17% and 1.63% (SLM) per annum would be a proper charge, if this rate is allowed by the Ministry of Company Affairs under section 205(2) of the Companies Act, 1956.

C. Points Considered by the Committee

11. The Committee notes that the basic objective of providing depreciation is to allocate the depreciable amount of an asset over its useful life so as to exhibit a true and fair view of the financial statements of an enterprise. In this regard, the Committee notes the definition of the term 'useful life' as contained in paragraph 3.3 of AS 6 and paragraph 20 of AS 6, which state as follows:

"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."

“20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.”

12. The Committee further notes paragraphs 7 and 8 of AS 6, explaining the term ‘useful life’, as follows:

“7. The useful life of a depreciable asset is shorter than its physical life and is:

- (i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
- (ii) directly governed by extraction or consumption;
- (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
- (iv) reduced by obsolescence arising from such factors as:
 - (a) technological changes;
 - (b) improvement in production methods;
 - (c) change in market demand for the product or service output of the asset; or
 - (d) legal or other restrictions.”

“8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is 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.”

13. The Committee also notes paragraph 13 of AS 6, which recognises the linkage between charge of depreciation under a statute

and that as per the generally accepted accounting principles, as reproduced in paragraph 7 above.

14. On the basis of the above, the Committee is of the view that in arriving at the rates at which depreciation should be provided, the company should consider the true commercial depreciation, i.e., the rate which is adequate to write off the asset over its useful life based on the technological estimates of the management. In case the useful life so worked out is less than the life arrived at as per the rates prescribed in Schedule XIV to the Companies Act, 1956 (in case of companies), the higher rate of depreciation, so arrived at is applied. However, in case the useful life works out to be longer, i.e., the rate so arrived at is lower than the rate prescribed by the statute, the rates prescribed in the relevant statute (Schedule XIV in case of companies) should be applied. In the concerned case, since Schedule XIV prescribes no specific rates of depreciation in respect of rolling stock, escalators and elevators, and track work involved in mass rapid transport system, the general rates applicable to ‘plant and machinery’ would be relevant. Accordingly, the useful life of 20 years (as arrived at from the general rate of depreciation as per Schedule XIV to the Companies Act, 1956), which is much shorter than the lives of the assets, as estimated by the management, should be considered for the purpose of calculating depreciation in the present case.

D. Opinion

15. The Committee is of the following opinion on the issues raised in paragraph 10 above:

- (a) Assuming that (i) the useful life of rolling stock and escalators and elevators is 30 years and that of track work is 58 years determined in accordance with the provisions of AS 6 and (ii) there are no legal stipulations as to the rate of depreciation,

charging depreciation as per SLM at the rates determined on the basis of the afore-mentioned lives of the respective assets would result in a true and fair view, provided provisions of section 205(2) of the Companies Act, 1956 are complied with.

(b) Charging of depreciation as per the SLM rates, based on estimated useful lives of the assets as per the provisions of AS 6 would be a proper charge, provided such rates are allowed by the Ministry of Company Affairs under section 205(2).

Notes:

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty-four volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.

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ICAI NEWS

Extension of last date to comply with the requirements of the Statement on Continuing Professional Education for the calendar year 2006 upto 31.3.2007

As per the provisions of the Statement on Continuing Professional Education, all the members in practice, unless exempted, are required to obtain to their credit a minimum of 20 CPE credit hours during the calendar year 2006.

It has been observed that due to the professional commitments and other technical reasons, number

of members have found it difficult to accumulate the required number of CPE credits as on date.

Accordingly, it has been decided to extend the last date of 31.12.06 upto 31.3.2007 to enable the members to accumulate the required number of CPE credits of twenty hours relating to the calendar year 2006.