Impact of Introduction of Revised Accounting Standards-10 on Indian Companies

Rachita Garg

Ramanujan College, University of Delhi
Email: rachitagarg@yahoo.com

Abstract. Corporate financial reporting in India has witnessed a sea change during the last three days. Several of the Accounting Standards (AS-2,AS-4,AS-13,AS-14,AS-21,AS-29) have been revised and AS-6 and AS-10 have been replaced by new and revised AS-10(Revised), Property, Plant and Equipment. Many developments have taken place at frequent intervals in matters relating to depreciation such as Component Accounting, estimation of useful life, treatment of spares and servicing equipment etc. these frequent changes have resulted in a lot of queries. The current paper seeks to provide an overview of changes in AS-10 and the impact of such changes on Indian Companies.

1 Introduction

On 30th March 2016, the Ministry of Corporate Affairs, (MCA) notified the Companies (Accounting Standards) Amendment Rules, 2016. The amendment rules have brought up huge changes. It has replaced the existing AS-10, Accounting for fixed assets and AS-6, Depreciation Accounting with new and revised AS-10(Revised), Property, Plant, Equipment. In addition, the amendment rules contain changes in the following Indian GAAP standards:-

- AS-2, Valuation of Inventories
- AS-4, contingencies and events occurring after the balance sheet date
- AS-13, Accounting for Inventories
- AS-14, Accounting for Amalgamation
- AS-21, Consolidated Financial Statements
- AS-29, Contingent Liabilities and Contingent Assets

All the companies following Indian GAAP and Accounting Standards are compulsorily required to follow such changes and incorporate them in their financial statements. This paper provides an overview of the key changes introduced and the need for such changes.

2454-342x electronic ISSN

1.1 Rationale of the Study

As globalization and Foreign Direct Investment are increasing day by day, the World is becoming small. Indian companies are expanding themselves in other parts of the world and foreign companies are also establishing their presence in India. All these companies while expanding have to face a few considerations that do not exist in their home countries. One of the major difficulties of these is to understand and interpret the Accounting Standards system in India which can pose a great challenge ahead. Although many steps have been taken in the past like introduction of International Financial Reporting Standards (IFRS), which provided a common set of accounting standards and rules for all the companies globally. This enabled many companies to compare their performance directly with other companies of the world. It was now possible to analyze the performance and profitability of companies and compare them with foreign companies before considering them for investment. It also improved consistency and transparency of financial reporting and provided better access to foreign capital markets and investment. But, IFRS was quite complex and costly, and if the adoption of IFRS is needed or required by Small and Medium Scale companies, it will be a big disadvantage for them. To overcome this hurdle, the ICAI has already introduced a new system Ind. AS (Indian Accounting Standards). These standards are converged with IFRS with some changes suitable for companies in India and are named and numbered in the same way as IFRS. The MCA, on 16th Feb. 2015 has also released a roadmap for the implementation of such Ind. AS. The map has intended to bring both domestic and foreign companies with a minimum net worth of Rs. 500 Crore into compliance with Indian Accounting Standards by April 1, 2016 and companies with a net worth of 250 crore or more but less than 500 crore by April 1, 2017. Comparative figures for the previous year will also be required.

However there are still some companies exempted from the above compulsory adoption. They will continue to use Indian GAAP and Accounting Standards. Following are the companies which are not covered in this roadmap:-

- Banking, Insurance and NBFCs have been excluded from this roadmap. It is expected that the implementation date for these companies shall be notified separately.

- Companies whose securities are listed or in the process of listing on SME exchanges. These companies shall continue to comply with the Accounting Standards unless they choose otherwise.

It is for these companies that some changes are introduced in the existing Accounting Standards to give them a more realistic approach. Among all the accounting standards it is only AS-6 and AS-10 that have undergone major changes. The changes introduced are in line with the existing Ind. AS 16 i.e. Property, Plant and Equipment.

3. Objective

- To study the need for changes in the existing Accounting Standards.
- To study the key impact of changes in AS-10 on Indian companies.
- To study the transitional provisions to be kept in mind while adopting AS-10(Revised).

4. Research Methodology

This paper is an exploratory research based on data collected through various websites and text of Accounting standards as notified by Ministry of Corporate Affairs. The data is also collected from popular books on Accounting standards and various publications by eminent researchers and companies like PwC, KPMG, Ernst & Young.

5. Key Changes and their Impact

AS-10, Fixed Assets is converged with Ind. AS 16, Property, Plant and Equipment and will super seede existing AS-10 and AS-6. Given below are the key differences and their impact:-

5.1 Component Accounting:-

Pre revised AS-10/AS-6:- IN THE PRE REVISED AS-6, component accounting is only recommended. However, it is not compulsory. “Component Accounting” requires a company to identify and depreciate significant components with different useful lives separately. The application of component accounting is likely to cause significant change in the measurement of depreciation.

Revised AS 10:- it has been made mandatory. As per Companies Act 2013 also, component accounting is mandatory from financial years commencing from April 1, 2015. The AS-10(Revised) in its paragraph 45 and 46 states that:-

45. “Each part of an item of Property, Plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.”

46. “An enterprise allocates the amount initially recognized in respect of an item of Property, Plant and Equipment to its significant parts and depreciates each such part separately. For Example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.”

*Key Impact:-*Now, entities will need to divide the total cost of the item into significant parts, if their useful life is different and depreciate them separately. This will require entities to restructure their fixed assets register and recomputed depreciation. Moreover, AS 10 does not contain any transitional provisions with respect to component accounting. Hence it cannot be restricted only to new assets acquired on or after April 1, 2015. Rather it also needs to be applied to all the existing assets of the company.

5.2 Major repairs and overhaul expenditure:-

Pre revised AS-10/AS-6:- in most cases, these are charged to the statement of profit and loss account as occurred. Only expenditure that increases the future benefits from all the existing assets beyond its previously assessed standard of performance is included in the gross book value.

Revised AS-10:- Because of component accounting, major repairs and overhaul expenditure are capitalized as replacement costs. The carrying amount of those parts that are replaced is derecognized. This occurs regardless of whether the replaced part has been depreciated separately. The recognition criteria of AS-10 (Revised) states that: “ the cost of an item of Property, Plant and Equipment should be recognized as an asset if and only if:-

- It is probable that future economic benefits associated with the item will flow to the enterprise; and
- The cost of the item can be measured reliably.

Key Impact: **-**Major inspections performed for faults regardless of whether parts of the item are replaced or not will be recognized in the carrying amount of the item of Property, Plant and Equipment as replacement cost if recognition criteria is satisfied. This cost is distinct from the cost of physical parts.

5.3 Spare parts, servicing and stand by equipments:-

Pre revised AS-6/AS-10:- Stand-by and servicing equipment should normally be capitalized as fixed assets. Machinery spares are usually treated as inventory and charged to profit or loss on consumption. However, spare parts that can only be used in connection with a particular item of fixed asset, and whose use is expected to be irregular, are capitalized. Such spare parts are depreciated over a period, not exceeding the remaining useful life of the principal asset.

Revised AS-10:- Items such as spare parts, stand-by equipment and servicing equipment are capitalized when they meet the definition of PPE, i.e., if the company intends to use these during more than a period of 12 months. Otherwise, such items are classified as inventory.

Key Impact: - Application of this approach may result in certain practical issues. For example, let us assume that an aircraft company owns a spare part that can only be used in a particular type of aircraft. The company owns only one such aircraft. In this case, it can capitalize the spare part and depreciate it over the useful life of the aircraft. However, if the company owns more than one aircraft in which the spare part can be used, it will treat the spare part as an inventory item to be charged to profit or loss on consumption. According to revised AS 10, all spare parts, standby equipment and servicing equipments qualify as fixed assets if they meet the definition of Property, Plant and Equipment.

Therefore, in the above case even if the company owns more than one aircraft, if that spare part meets the definition of Property, Plant and Equipment , it will be depreciated separately. The transitional provisions states that if a spare part, which was previously recognized as inventory, is required to be capitalized at its carrying amount and depreciated prospectively over its remaining useful life.

5.4 Enabling Asset:-

Pre revised AS-10/AS-6:- No specific mention for unit of measure. Certain Expert Advisory Committee opinions prohibit capitalization of enabling assets.

Revised AS-10:- Specifically recognizes "unit of measure" approach, for instance, for recognition of certain expenditure incurred on construction of assets not owned by an enterprise during the construction stage of a project. For example, a road constructed by an enterprise on government land which is not owned by the enterprise and over which it does not have exclusive control as the road can be used by general public, can be capitalized as a part of the project cost if such a road is constructed to facilitate the construction of the manufacturing plant itself because this cost is considered necessary for the project to be capable of operating in the manner intended.

Key Impact: - Many companies incur capital expenditure on items not owned by them. For example, a company setting up a refinery in an under-developed area may need to incur expenditure on the construction of, for example, an access road and electricity transmission lines (enabling assets). In the pre-revised AS 10 scenario, the Expert Advisory Committee (EAC) of the ICAI has dealt with accounting for enabling assets in certain opinions, e.g., opinion on the subject "Treatment of capital expenditure on assets not owned by the company." published in the January 2011 edition of the ICAI Journal. These opinions state that a company cannot capitalize expenditure incurred on enabling assets, since these are available for public use and the company does not control them. Consequently, the company needs to charge costs incurred on enabling assets to the statement of profit and loss immediately. This was expected to have a significant impact on the financial statements of many companies in the construction phase.

While many companies believe that arguments can be made to capitalize enabling assets under pre-revised AS 10, the revised AS 10 has settled this issue in a conclusive manner. The revised AS 10 introduces the concept of a "unit of measure" to identify an item of a PPE that is eligible for capitalization. The standard does not adopt a prescriptive approach in defining a "unit of measure," but a company is required to exercise its judgment based on its facts and circumstances. Hence, if a company can demonstrate that the project under construction and enabling assets are one "unit of measure," it can capitalize the expense incurred on the enabling assets as the cost of the project.

In accordance with the transitional provisions, companies may apply this amendment retrospectively for a project. Any impact arising from the retrospective application, as adjusted by related tax expense, is recognized in the revenue reserves. Therefore if an entity in the past has recognized some expenditure in the statement of profit and loss account but now it is eligible to be capitalized, then it should be recognized as cost.

5.5 Cost of item of PPE:-

Pre revised AS-10/AS-6:- Except in case of assets acquired on hire purchase, entities are not required to separate finance element even if an asset is purchased on deferred payment basis. The general practice is not to discount future cash flows.

Revised AS-10:- Except in case of assets acquired on hire purchase, entities are not required to separate finance element even if an asset is purchased on deferred payment basis. The general practice is not to discount future cash flows.

Key Impact:- Entities may acquire assets on such contracts where payment has been delayed for significant period of time. In deferred payment contract actual cash outflow may occur after 5-10 years of actual purchase. Under such contracts, the deferred portion of consideration will be recorded on present value basis in the cost of assts. However, unwinding charge will be treated as finance cost of the period and recorded in the income statement instead of being capitalized as cost of the assets.

The discount rate to be used for present value calculations must be known for the period over which payment is deferred must also be known with certainty. Usually it is written as part of contract or a separate instrument is used like bond.

5.6 Review or determination of useful lives:-

Pre revised AS-10/AS-6:- Schedule II to the Companies Act, 2013, prescribes useful lives for various items of PPE. It also fixes residual value for items of PPE at 5% of the original cost. If a company adopts a useful life/ residual value different from that specified in Schedule II, the financial statements should disclose such difference and provide justification in this behalf duly supported by technical advice. In accordance with the approach used in AS 6, a company has an option to treat useful lives and residual value prescribed in Schedule II as maximum limit. Alternatively, the management can use the same as indicative only and also it does not mandate

an annual review of useful lives, depreciation method and residual values, but recommends periodic review of useful lives.

Revised AS-10:- Does not mandate an annual review of useful lives, depreciation method and residual values, but recommends periodic review of useful lives.

Key Impact:- The residual value and useful life of an asset should be reviewed at least at each financial year end and, if expectation differ from previous estimate in accordance with AS-5, Net profit or loss for the period, prior period items and changes in accounting policies. The depreciable amount of an asset is determined after deducting its residual value. The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero unless and until its residual value subsequently decreases to an amount below its carrying amount.

5.7 Change in Depreciation Method:-

Pre revised AS-10/AS-6:- Any change in depreciation method is treated as an accounting policy change and applied retrospectively. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in the statement of profit and loss for the period of change.

Revised AS-10:- It is treated as a change in accounting estimate and applied prospectively.As a consequence, change in depreciation method will not result into any cumulative adjustment to be recognised in the statement of profit and loss. Rather, consequent depreciation adjustment should be made prospectively, i.e. the asset's depreciable amount should be written off over the current and future periods.

5.8 Revaluation Model:-

Pre revised AS-10/AS-6:- Recognizes revaluation of fixed assets. However, the revaluation approach adopted therein is ad hoc in nature, since it does not require the adoption of fair value basis as its accounting policy or revaluation of assets with regularity. It also provides an option for selection of assets within a class for revaluation on systematic basis.

Revised AS-10:- Requires a company to choose either the cost model or the revaluation model as its accounting policy and to apply that policy to an entire class of PPE. It requires that under the revaluation model, revaluation should be made with reference to the fair value of items

of PPE. It also requires that revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from the amount determined using fair value at the balance sheet date.

Key Impact:- If revaluation model is adopted, it should be adopted with regularity and should be applied to only that class of property, plant and equipment whose fair value can be reliably measured. If cost model is adopted then the asset should be carried at its cost less any accumulated depreciation and any accumulated impairment losses. Here, the frequency of revaluation depends upon the changes in fair value of the items being revalued.

6. Conclusions

Although it is certain that these changes will make the financial statements more reliable and will provide a realistic approach in valuing fixed assets. But these changes will come with its own challenges. Training of professionals in implementing these changes will be the biggest hurdle, measurement of fair value every year will become difficult if complete information as to current market price is not available. In the initial year of adoption complexities will arise in complying with the transitional provisions. The retrospect application of some provisions will affect the profit and loss statement of the previous years also. Therefore, management should take due care and diligence while adopting these provisions and should train their staff in advance for effective implementation.

7. References

- ey.com/in/en/services/assurance/assurance_library
- www.mca.gov.in/ministryV2/stand.html
- Dr. Sanjeev Singhal, Rachita Garg (2017) : Student's Guide to Accounting Standards.
- Dr. Sanjeev Singhal, Rachita Garg (2017) : Student's Guide to Depreciation.
- https:/www.mca.gov.in.>pdf>AS-10.
- https:/www.mca.gov.in.>pdf>AS-16.
- https://www.pwc.in>pdfs>services>ifrs.
- https://caclub.in>difference-between-ind-as-16-and-as-10-and-as-6.
- www.icai.org.