

Query No. 16

Subject: Date of commencement of commercial production of Multilayer Double Coated Paper Board Green Field Project and capitalisation of borrowing costs incurred during the test run period of the Project.¹

A. Facts of the Case

1. T Limited is a listed company, promoted by the Government of Tamil Nadu (GOTN) to manufacture newsprint and printing and writing paper (PWP) using bagasse (a sugar cane waste) as primary raw material. It has a paper production capacity of 4,00,000 MT per annum. The company has set up a green field Multilayer Double Coated Board Plant (hereinafter referred to as MDCB plant) to produce packaging boards of 2,00,000 MT per annum at a capital outlay of Rs.1,650 crore in Tamil Nadu. The scope of MDCB project includes setting up a board machine, a 30 MW power plant and other support infrastructures like power sub-station, water treatment plants, mill-wide air conditioning system, automatic storage retrieval systems, etc.

2. The querist has stated that MDCB plant is installed to manufacture high-end coated boards for making carton boxes for packaging food and beverages, pharmaceuticals, personal and health care products, electronic goods, etc. In the coated board market, product quality is very critical. The products have to be of high quality to avoid rejection by customers. T Limited started the test run of the MDCB plant without the coating section on 21.01.2016. The test run of the coating section which is vital, began on 17.02.2016. Production till end of February 2016 was largely uncoated and therefore, rejected and re-pulped. Board production during 01.03.2016 - 14.3.2016 was 32.77% of the machine capacity, of which 46.10% of production was rejected and re-pulped as the product did not meet the quality standards. Generally, rejection level should be less than 5% of production. The plant continued the test run beyond 14.3.2016 till 30.04.2016 for making further technical adjustments in the machine to meet quality standards, reduce the rejection level and achieve commercially feasible/viable production.

3. The querist has also stated that between 15.03.2016 and 30.04.2016, the company produced 12,122 MT equivalent to 46.42% of the machine capacity. Of this, 2,336 MT equivalent to 19.27% of production was rejected and re-pulped. With the technical adjustments carried out, the rejection level declined to 6.59% of production during the last week of April 2016. With the declining trend in the rejection level, the company considered that the plant was ready for commercial production from 01.05.2016.

4. The company ceased capitalisation of borrowing cost with effect from 15.03.2016 on substantial completion of all activities necessary to prepare the MDCB plant for production of coated boards, in accordance with paragraph 19 of Accounting Standard (AS) 16, 'Borrowing Costs'. At this point, the production was 32.77% of the machine capacity and 46.10% of production was below the quality standards and, therefore, rejected and re-pulped. High level of rejection reinforces the need to carry out further technical adjustments in the machine. Therefore, test run was continued till 30.04.2016 to meet quality standards and reduce the rejection level. The company treated all directly attributable costs of the MDCB project and all indirect construction costs (including cost of start-up & commissioning, test run and experimental production net of income earned) incurred as 'capital work-in-progress' as on 31.03.2016. As the company ceased

¹ Opinion finalised by the Committee on 26.10.2016.

capitalisation of borrowing cost effective from 15.03.2016, the borrowing cost for the period 15.03.2016 - 31.03.2016 was charged off to the statement of profit and loss during the financial year 2015-16.

5. The querist has further stated that the Comptroller and Auditor General (CAG) in the course of supplementary audit u/s 143(6)(a) of the Companies Act, 2013, for the financial year (F.Y.) 2015-16, has made a comment as under:

“The company decided that Unit II of Multilayer Double Coated Board (MDCB) (which had been commissioned on 21.01.2016) be in test run up to 14th March 2016 and declared that plant was ready to commence commercial production on 15th March 2016. In accordance with the provisions of AS 16, capitalisation of interest cost was ceased from that date. However, income from sales continued to be adjusted against Capital Work in Progress instead of showing the same as sales in profit and loss account. This has also resulted in understatement of profit by Rs.2.53 Crore.

Further, as Unit II of MDCB was ready to commence the commercial production on 15th March 2016, continuation of the same under Capital Work in Progress as on 31st March 2016 is incorrect.

According to the querist, the CAG’s comment is based on the premise that the company completed the test run of the MDCB project on 14.03.2016, i.e., on the date of cessation of borrowing cost and the plant was ready to commence commercial production on 15.03.2016. (Emphasis supplied by the querist.)

Company’s stand:

6. As per paragraph 19 of AS 16 **“Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete”**. The criteria for cessation of borrowing cost under AS 16, according to the querist, is *linked to substantial completion of all activities necessary to prepare the qualifying asset. The criteria for capitalisation of costs under AS 10, ‘Accounting for Fixed Assets’² is linked to the date of readiness of the plant to commence commercial production. Thus, AS 10 and AS 16 have to be dealt with independently as the principles/criteria for accounting treatment in the respective standards are different. Further, since AS 16 specifically deals with the accounting treatment of borrowing cost, the same will override AS 10. Footnote 1 to paragraph 9.4 of AS 10 also confirms this position, the relevant portion of which is reproduced below:*

“...Since Accounting Standard (AS) 16, Borrowing Costs specifically deals with the treatment of borrowing costs, the treatment provided by AS 16 would prevail over the provisions in this respect contained in this paragraph as these provisions are general in nature and apply to “all expenses”.”

(Emphasis supplied by the querist.)

² The opinion should be read in the context of pre-revised Standard, viz., Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’. However, it may be noted that the Standard has been subsequently revised as AS 10, ‘Property, Plant and Equipment’ by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

7. MDCB plant is a self-constructed asset. Activities necessary to prepare the MDCB plant for production were substantially completed on 14.03.2016, with production at 32.77% of the machine capacity and rejection level at 46.10% of production. As all activities necessary to prepare the MDCB plant for production of coated boards were substantially completed on 14.03.2016, the company ceased capitalisation of borrowing cost with effect from 15.03.2016 to comply with the *mandatory* accounting requirements of paragraph 19 in AS 16 and continued the test run beyond 14.03.2016 to improve the quality standards and reduce the rejection to the normal level. With rejection level at 46.10% in the production of 32.77% of machine capacity during the period 1.3.2016 to 14.03.2016, it was not prudent to consider that the plant was ready to commence commercial production on 15.03.2016. Generally, rejection level should be less than 5% of production.

8. The querist has stated that continuation of test run beyond 14.03.2016, the date of cessation of capitalisation of borrowing cost, was not due to abnormal / extraneous reasons but primarily to attend to the technical issues in the machine so as to meet quality standards and reduce the rejection level. *The Multilayer Coated Board Machine is highly sophisticated with DCS controls inbuilt into every section of the machine. The machine requires regular technical adjustments of its electrical and electronic parts for producing coated boards with consistent quality and commercially feasible quantity. These technical adjustments have to be carried out on a continuous basis when test run production is on. These adjustments take considerable time and other companies who have installed board machines in their plants have had the experience of longer test run even upto 10 – 12 months before declaring commercial production.* (Emphasis supplied by the querist.)

9. The company started the test run of MDCB plant with coating section only on 17.02.2016. Production during the last week of the January and most of February was largely uncoated and therefore rejected and re-pulped. *The company, in the midst of test run of the MDCB Plant, ceased capitalization of borrowing cost on 14.03.2016 i.e. the date on which all activities necessary to prepare the MDCB plant for production were substantially completed for the limited purpose of complying with the mandatory accounting requirements as per paragraph 19 of AS 16.* Board production during 1.3.2016 - 14.3.2016 was 2,548 MT equivalent to 32.77% of the machine capacity. Of this, 1,175 MT equivalent to 46.10% of production, was rejected and re-pulped as the product did not meet the quality standards. *With 46.10% of production being rejected on quality considerations in the production of 32.77% of capacity being achieved, it was hardly possible to declare 15.03.2016 as the date of readiness of MDCB plant for commercial production. High level of rejection reinforces the need to carry out further technical adjustments in the machine. Therefore, test run was continued till 30.04.2016 to meet quality standards and reduce the rejection level.* Between 15.03.2016 and 30.04.2016, the company produced 12,122 MT equivalent to 46.42% of the machine capacity. Of this, 2,336 MT equivalent to 19.27% of production was rejected and re-pulped. *With the technical adjustments carried out, the rejection level in the last week of April 2016 declined to 6.59% of production. With the declining trend in the rejection level, the company considered that the plant was ready for commercial production from 01.05.2016.* (Emphasis supplied by the querist.)

10. Thus, the company considered all the relevant factors, such as, technological evaluation of the readiness of the plant & machinery and other facilities, the quality and quantity of the output produced etc., and reckoned 01.05.2016 as the date of readiness of the MDCB plant to commence commercial production. Since the MDCB plant continued the test run till 30.04.2016 for the reasons stated above, the company treated all directly

attributable costs of the MDCB project, borrowing cost up to 14.03.2016 (date of cessation of capitalization under AS 16) and all indirect construction costs (including cost of start-up & commissioning, test run and experimental production net of income earned) incurred as ‘capital work-in-progress’ on 31.03.2016. *Having regard to the facts and circumstances of the case, the main issue now is whether MDCB Plant should be considered ready to commence commercial production on 15.03.2016 or 01.05.2016.* (Emphasis supplied by the querist.)

11. The querist has also stated that the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) in its earlier opinion finalized on 5.7.2001 (published as Query No. 25 of Volume XXI of the Compendium of Opinions), besides defining the term “commercial production” has also discussed in length, the factors to be considered for determining when a plant is ready to commence commercial production, the relevant extracts are given below:

- (i) “Duration of a trial run and experimental production and when the plant is ready for commercial production is based on factors such as technological evaluation of the readiness of the plant and machinery and other facilities, the quality and the quantity of the output produced, etc... when the plant is ready for commercial production, is a question of fact which should be determined on the basis of the factors stated above.”
- (ii) “It should be borne in mind... that “commercial production” is a term of somewhat wider import than the mere term “production”. Even during a period of test runs and experimentation, a plant may be engaged in actual production, but until the test runs are completed and the plant is properly adjusted on the basis thereof, it may not be said to be ready for “commercial production”. The term “commercial production” refers to production in commercially feasible quantities and in a commercially practicable manner.”

It is apparent from the above explanatory notes of the EAC of the ICAI that the issue when a plant can be considered ready for commercial production depends on various factors, such as, *technological evaluation of the readiness of the plant and machinery and other facilities, the quality and the quantity of the output produced, etc.*, which are all business related. Therefore, when a plant is ready to commence commercial production is an issue of business judgement to be exercised by the management having regard to all relevant technological and commercial factors as above. (Emphasis supplied by the querist.)

12. The querist has also separately raised a supplementary issue with regard to capitalisation of borrowing costs incurred during the test run period of the project and supplied the views of the company on the issue as follows:

Having commenced production in the MDCB plant, the company ceased capitalization of interest effective from 15.03.2016 even with high rejection level at 46.10% of production. The company continued test run beyond 14.03.2016. On the date of cessation of borrowing costs i.e., on 14.03.2016, the production standard could not be met as 46.10% of the production was being rejected on quality considerations in the meager production of 32.77% of machine capacity. This warranted necessary alterations / modifications to the plant and machinery and the corrections were carried out during the test run period from 15.03.2016 to 30.04.2016.

As a result of the above corrective measures in the board machine, the rejection level was reduced from 46.10% to 19.27% during the period 14.03.2016 - 30.04.2016 and further to 6.59% in the last week of April 2016. With declining trend in the rejection level, the company completed the test run on 30.04.2016. On 01.05.2016, the plant was ready to commence commercial production when the company achieved normal production standards. According to the querist, as per AS 16 (paragraph 19 read with paragraph 20), capitalisation of borrowing costs need not be ceased unless and until all *activities necessary to prepare the qualifying assets for its intended use are complete*. However, paragraph 20 of AS 16 envisages certain activities, viz., routine administrative and minor modification work which have no bearing on bringing the qualifying asset to its working condition for its intended use and therefore, mandates cessation of borrowing costs during the pendency of these non-core activities.

In the subject case, the activities undertaken by the company during the period 15.03.2016 – 30.04.2016 were not of the non-core activities envisaged in paragraph 20 of AS 16 but were part of normal trial run activities (a core construction activity of plant) without which intended use of the qualifying asset cannot be achieved.

Further, continuation of test run beyond 14.03.2016 till 30.04.2016 was not due to any abnormal reasons but primarily to correct technical defects and improve the quality, reduce the rejection level from 46.10% to the acceptable level of around 5% and achieve commercially feasible quantities. *Such corrective activities during the trial run production period are must to bring the plant for its intended use*. Therefore, continuation of test run from 15.03.2016 – 30.04.2016 was a *normal* period of test run.

The Expert Advisory Committee of the ICAI in various opinions issued on the matter of capitalization of asset, have issued clarificatory notes highlighting the criticality of test run activity in the context of construction of a plant and the accounting treatment to be given in respect of expenditure incurred during the trial run period. The relevant extracts have been provided by the querist as below:

- (i) Normal trial run also contributes to construction of plant as trial run activity is regarded as an activity which is necessary to prepare the asset for its intended use. This is because flaws in the assets noticed during trial run production are rectified to bring the plant to its intended use. (Paragraph 21 of EAC Opinion finalised on 05.07.2001)
- (ii) The purpose of the test run is to ascertain whether the plant and machinery and other relevant facilities, as installed, give the commercially feasible output in terms of quality and quantity. If, during the test run, the production standards are not met, normally, the production is stopped and necessary alterations / modifications are made in the plant and machinery. It may be necessary to carry out test run(s) further until the output of commercially feasible quality and quantity is obtained. (Paragraph 11 of EAC Opinion finalised on 31.07.2012 and published as Query No. 18 of Volume XXXII of the Compendium of Opinions)
- (iii) As per the requirements of AS 16, borrowing costs related to construction of an asset incurred upto the time the asset is ready for its intended use, i.e.,

ready to commence commercial production, should be capitalised, and, thereafter, all borrowing costs should be charged to revenue. (Paragraph 20 of EAC Opinion finalised on 05.07.2001)

- (iv) *The borrowing costs incurred during the normal period of trial run should be capitalised. (paragraph 22 (b) of EAC Opinion dated 5.7.2001)*

Considering the facts and circumstances of the case, the relevant Accounting Standard and the views of the EAC as above, the company is of the view that the company should have continued capitalisation of borrowing costs incurred during the normal period of the test run, i.e., upto 30.04.2016.

B. Query

13. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee (EAC) on the following issues:

- (i) On the basis of the facts mentioned as above, with rejection level at 46.10% of production, which is 32.77% of machine capacity, whether the MDCB plant should be considered as ready to commence commercial production, i.e., on 15.03.2016.
- (iii) With further technical adjustments carried out in the machine between 15.03.2016 and 30.04.2016 and the rejection level reduced to 6.59% in the last week of April 2016, whether the company can consider 01.05.2016 as the date of readiness of the plant to commence commercial production.
- (iv) Whether the action of the company in ceasing capitalisation of borrowing cost on 14.03.2016 despite continuation of normal test run of MDCB plant upto 30.04.2016 was correct and if not, whether 30.04.2016 can be taken as the cut-off date for cessation of capitalisation of borrowing costs for the purpose of AS 16.

C. Points considered by the Committee

14. The Committee notes that the basic issues raised in the query relate to the point of time when the MDCB plant should be considered to be ready to commence commercial production and the cut-off date to be taken for cessation of capitalisation of borrowing costs for the purposes of AS 16. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, elements of costs (direct and indirect) which need to be capitalised with the plant, etc. At the outset, the Committee wishes to point out that since the querist has referred to the provisions of Accounting Standard (AS) 10 (pre-revised), 'Accounting for Fixed Assets', the Committee has considered the requirements of pre-revised Standard and not the requirements of revised Accounting Standard (AS) 10, 'Property, Plant and Equipment'. Further, since the company was operating at a certain specified level of production during 15.3.2016 to 30.4.2016, the Committee presumes from the Facts of the Case that such a level of production was normal and essential for the trial run to commence considering the nature of the process of the industry in which the company is operating (failing which the opinion of the Committee may not be applicable). Moreover, since the time gap between the date of cessation of capitalisation of borrowing costs, i.e., 15.3.2016 and the date when the plant is ready to commence commercial production, i.e.,

1.5.2016 was 1.5 months only and as per the accounting requirements, Accounting Standards are intended to apply to items which are material, it is also presumed that the amounts involved in the extant case are material.

15. The Committee notes from the Facts of the Case that during 1.3.2016 to 14.3.2016, the production was 2,548 MT equivalent to 32.77% of the machine capacity and of this, 1,175 MT equivalent to 46.10% of production was rejected and re-pulped as the product did not meet the quality standards. However, on 15.3.2016, the company ceased the capitalisation of borrowing costs under AS 16. Further, between 15.03.2016 and 30.04.2016, the company produced 12,122 MT equivalent to 46.42% of the machine capacity. Of this, 2,336 MT equivalent to 19.27% of production was rejected and re-pulped. With the technical adjustments carried out, the rejection level declined to 6.59% of production during the last week of April 2016. Thus, the issue raised is with respect to whether 15.03.2016 on which the borrowing costs were ceased to be capitalized should be considered as the date of readiness of the plant to commence commercial production. Accordingly, the issue does not pertain to consideration of readiness of plant before 15.3.2016. Therefore, the Committee is concentrating on the issue raised only. On the basis of the above-mentioned facts, the Committee notes that although on 15.03.2016, the plant was operating, but was functioning at sub-optimum level, viz., somewhere between 32.77% and 46.42%. Further, the output produced at this capacity was being sold, though the rejection level as on that date was somewhere between 19.27% to 46.10% of the production. On this basis, the querist has contended that the plant cannot be considered as ready to commence commercial production on 15.3.2016 and the period between 15.3.2016 to 30.4.2016 should also be considered as the period of trial/test run of the plant and therefore, the plant should be continued as capital work in progress till 30.4.2016 in the books of account. Thus, the Committee notes that the issues to be examined are the duration of test run and the point of time at which the cost of the plant should be capitalized as fixed asset in the financial statements. In this regard, the Committee notes the following requirements of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

“9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production, i.e., production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.

9.4 If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement. ...”

From the above, the Committee notes that the above provisions require expenditure on test runs and experimental production to be capitalised as an element of cost of an asset till it is ready to commence commercial production and then the same to be capitalised as a fixed asset (the plant). The Committee is of the view that the duration of trial run and the date when an asset is ready to commence commercial production is a question of fact which should be determined on the basis of various factors, such as, technological evaluation of the readiness of the asset, the quality and the quantity of the output

produced, etc. Commercial production means production in commercially feasible quantities and in a commercially practicable manner. Thus, if an asset is operational and is able to produce the commercially feasible quality and quantity of goods, no further costs should be capitalised as fixed asset even if it is not achieving targeted production. The Committee is further of the view that what is important is when the asset/plant is ready to commence commercial production and not the capacity of the plant achieved. Moreover, commercially feasible quality means an acceptable quality level that is commercially feasible to be sold in the market and the same should be determined considering the past experience (if any), target market, industry practice, etc. Thus, the Committee is of the view that the date of readiness of the plant to commence commercial production should be determined considering the afore-mentioned factors and not solely on the basis of the capacity or level of production.

16. With regard to the supplementary query raised by the querist related to the point of time when the capitalization of borrowing costs on a qualifying asset should cease, the Committee notes paragraphs 19 and 20 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the 'Rules', reproduced below:

“19. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.”

From the above, the Committee notes that the Standard requires cessation of borrowing costs when the activities necessary to prepare the qualifying asset for its intended use are complete. In other words, borrowing costs should cease to be capitalized after the qualifying asset is ready for its intended use. The Committee is of the view that normally, when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete i.e., when the qualifying asset is ready for its intended use, the asset would also be ready to commence commercial production. The Committee agrees with the view of the querist that test/trial run is also an essential part of the construction activity to prepare the asset ready for its intended use and therefore, the borrowing costs incurred even during the test/trial run should be continued to be capitalized. However, the duration of test/trail run should be determined considering the factors as aforementioned in paragraph 15 above.

17. Incidentally, the Committee notes from the Facts of the Case that the CAG has commented that the plant had been commissioned on 21.01.16 and that the plant was declared to be ready to commence commercial production on 15th March, 2016. However, the Committee also notes that the querist has stated that the company considered that the plant was ready for commercial production from 1.5.2016 and reckoned 1.5.2016 as the date of readiness of the MDCB plant to commence commercial production. Thus, it is not clear that whether the plant was declared to be ready to commence commercial production on 15th March, 2016 or not. However, in this regard, the Committee wishes to point out that once considering all the above-mentioned factors, as discussed in paragraph 15 above, a plant has been declared as ready to commence commercial production, it cannot be said

later that the plant was not so ready due to not achieving the targeted level of production or sale due to rejection level, etc.

D. Opinion

18. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 13 above:

- (i) and (ii) whether the MDCB plant should be considered as ready to commence commercial production on 15.03.2016 or on 01.05.2016, is a question of fact which should be determined on the basis of various factors, such as, technological evaluation of the readiness of the asset, the quality and the quantity of the output produced, etc., as discussed in paragraph 15 above.
- (iii) The test/trial run is also an essential part of the construction activity to prepare the asset ready for its intended use and therefore, the borrowing costs incurred even during the test/trial run should be continued to be capitalized, as discussed in paragraph 16 above. However, the duration of test/trail run should be determined considering the factors as aforementioned in paragraph 15 above.
