

Query No. 5

Subject: *Accounting treatment of unutilised spare parts to be used on renovation and modernisation (R&M) of Power Plant.*¹

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is a subsidiary company of another company (100% Government of Gujarat undertaking) having installed capacity of 5894 Mega Watt (MW). The company is having 2 units of 120 MW thermal power plants at Gandhinagar commissioned on 13-03-1977 for Unit-I and 10-04-1977 for Unit-II. [Both units have completed 38 years of life, which is normally 25 years (as per life prescribed by Central Electricity Regulatory Commission) and with R&M it will be 35 years of life]. As per the directives of Central Electricity Authority (CEA), the company has carried out renovation and modernisation (R&M) work during the financial year (F.Y.) 2007-08 to 2009-10. The company has given an Engineering, Procurement and Construction (EPC) contract to M/s XYZ to complete R & M work for the said units. As per this, M/s XYZ, an EPC contractor, has supplied materials and carried out some work in coal handling plant and ID fan etc. However, the company has a bitter experience of other power plants for not achieving the targeted efficiency. Therefore, the company has cancelled the order placed on M/s XYZ for R&M of 2 units of 120 MW each at Gandhinagar thermal power station (TPS). M/s XYZ has completed some work upto the date of cancellation of order. The company is seeking guidance for the above subject matter in context to the following information:

- (i) As per Accounting Standard (AS) 10, 'Accounting for Fixed Assets'², fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.
- (ii) Stand-by equipment and servicing equipments are normally capitalised. If the machinery spares can be used only in connection with an item of fixed asset and their use is expected to be not frequent, it may be appropriate to allocate total cost on a systematic basis over a period not exceeding useful life of principal item.
- (iii) Improvement of assets: According to the querist, the R & M (improvement) subsequent expenditure related to very old fixed asset is to be capitalised because the expenditure that increases future benefit from the existing assets beyond its previously assessed standard of performance is included in the gross book value, i.e., an increase in the capital.

2. The querist has stated that during this period, the company has carried out following entries in the books of account:

- (i) Whatever work completed and shown in capital work in progress has been transferred to fixed assets of 'Plant & Machinery' during the F.Y. 2009-10 and F.Y. 2011-12.

¹ Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

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.

- A) Purchase (Capital) A/c. Dr.
To M/s XYZ (Party) A/c

(Being entry passed for purchase of capital nature material from M/s XYZ to carry out R & M.)

- B) Capital work in progress A/c. Dr.
To Purchase (Capital) A/c.

(Being entry passed to transfer capital nature material and work to work in progress).

- C) Plant and Machinery A/c Dr.
Capital Spares A/c. Dr
To Capital work in progress A/c.

(Being entry passed for transfer of work in progress to fixed assets and capital spares on work completion).

Gandhinagar Thermal Power Station Unit 1 & 2

Renovation and Modernisation (R&M)

Year	Addition in capital work in progress-WIP (Rs. in lacs)	Transferred to fixed asset (Rs. In lacs)	Statutory auditors' qualification	C&AG qualifications
2007-08	125.08	0		
2008-09	10176.86	0		
2009-10	8031.08	18333.01	NIL	NIL
2010-11	3321.18	0	NIL	NIL
2011-12	1161.52	4482.70	NIL	NIL
2012-13	0.00	0.00	NIL	NIL
2013-14	0.00	0.00	Yes	NIL
2014-15	0.00	0.00	Yes	NIL
Total	22815.71	22815.71		

The company depreciates plant and machinery as per Central Electricity Regulatory Commission (CERC) rate and capital spares on the basis of useful life of plant as per AS 10.

- (ii) Unutilised material/spares of plant and machinery not installed are shown separately under the head of 'Capital Spares' and charged depreciation as per AS 10 i.e., depreciation to be charged during the useful life of plant and machinery.
- (iii) The Gujarat Electricity Regulatory Commission (GERC) has approved the expenditure and allowed the addition of fixed assets and depreciation thereon as per CERC norms. The company, being a power generating company, is governed under the Electricity Act, 2003.

- The company has considered material purchased under above contract as capital nature spares with an intention to use in plants. So it was capitalised from the beginning.
- The statutory auditors have considered the fixed assets as per AS 10 for F.Y. 2010-11, 2011-12 and 2012-13 and given clear (unqualified) report to the company.
- The competent authority of GERC has considered the addition of fixed assets and capital spares and allowed depreciation, loan, return on equity etc. Further, the commission has approved tariff upto F.Y. 2015-16 only and hence, the company has re-assessed the life of plant. The company has charged the additional depreciation to achieve 90% depreciation up to life of plant, i.e., upto financial year 2015-16 as per CERC norms. And also for the capital spares, depreciation is charged to amortise capital spares 100% upto life of plant.
- During the F.Y. 2013-14 and 2014-15, the statutory auditors have taken a different view for CWIP and capitalization done (F.Y. 2007-08 to F.Y. 2011-12) and qualified their report considering this as current assets and not of the nature of capital spares.
- Further, C&AG has carried out supplementary audit and given Nil audit comments. According to the querist, the qualification of statutory auditors has not been considered by C&AG Office because the nature is, as such, the capital nature and treatment is as per generally accepted accounting principles. As narrated above, the company's statutory auditors for the year 2011-12 and 2012-13 and internal auditors, Commission and C&AG have considered it as capital nature.

3. The querist has separately explained with regard to the nature of the spares that as these spares were purchased for renovation and modernisation, (for the plant whose life is over) its nature is capital. However, due to non-achieving the parameters by the original equipment manufacturers, the company has carried out bare minimum renovation and modernisation work for the purchase materials and balance material will be used in other similar unit of the company as and when required. Hence, it is inter-changeable with similar capacity unit and can also be used with other similar plant and machinery of other units of the company.

B. Query

4. The company has treated these spares as capital nature and shown under the head 'fixed assets' due to above reasons and hence, the querist has sought the opinion of the Committee as to whether this accounting treatment is in conformity with Accounting Standards and GAAPs.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to treatment of unutilised (not installed) spares and material (assumed to be of the nature of spares) of plant and machinery as capital spares. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, depreciation on plant and machinery and capital spares, accounting treatment of expenditure on renovation and modernisation, accounting entries passed in respect of transfer of work completed and shown in capital work in progress to fixed assets of plant and machinery (as

provided in paragraph 2 above), etc. At the outset, it is presumed that spares kept for future use are ready for their intended use. The opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 and without considering the application of Accounting Standards amended by MCA vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification. Further, the Committee wishes to point out that opinion expressed hereinafter is purely from accounting perspective and not from the perspective of determination of tariff as per CERC/GERC.

6. With regard to the issue raised, the Committee notes the requirements of Accounting Standard (AS) 2, 'Valuation of Inventories'³ and AS 10, as follows:

AS 2

“4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.”

AS 10

“8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.”

From the above, the Committee notes that the accounting treatment of machinery spares depends upon their nature, viz., whether these spares can be used only in connection with an item of fixed asset and their use is expected to be irregular. The Committee is of the view that machinery spares which are specific to a particular item of fixed asset, i.e., they can be used only in connection with a particular item of the fixed asset and their use is expected to be irregular can only be considered and capitalised as capital spares. In other words, machinery spares which are not specific to a particular item of fixed asset but can be used generally for various items of fixed assets should be treated as inventories for the purpose of AS 2. The Committee is further of the view that the capital spares as per AS 10 can be used only in relation to a specific item of fixed asset, and, accordingly, they are to be discarded in case that specific fixed asset is disposed of. In other words, such spares are integral parts of the fixed asset.

³ The opinion should be read in the context of pre-revised Accounting Standard (AS) 2, 'Valuation of Inventories'. However, it may be noted that certain requirements of the Standard have been amended 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. In the light of above discussion, the Committee notes from the Facts of the Case that the material/spares in the extant case were purchased originally for renovation and modernisation of a plant whose life is over. However, due to some reasons, those could not be used for that purpose and, therefore, the material/spares unutilised were kept to be used in other similar unit of the company as and when required. Further, the querist has also stated that these are inter-changeable with similar capacity unit of the company and can also be used with other similar plant and machinery of other units. From the above, the Committee is of the view that since these are inter-changeable with similar units and similar plant and machineries, these cannot be considered as specific to a particular item of fixed asset and, therefore, these cannot be treated as capital spares to be shown under 'fixed assets'. Accordingly, these spares should be treated as inventories.

D. Opinion

8. On the basis of the above, the Committee is of the view that for the reasons mentioned in paragraphs 6 and 7 above, the unutilised material/spares cannot be treated as capital spares and, therefore, the accounting treatment accorded by the company is not in conformity with Accounting Standards and GAAPs.
