

Query No. 6

Subject: *Accounting treatment of machinery/capital spares on replacement of worn out parts.*¹

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is a subsidiary company of another company (100% Govt. of Gujarat undertaking) having installed capacity of 5894 Mega Watt (MW). The company is registered under the Companies Act, 1956 and governed by the Electricity (Rules & Regulations) Act, 2013. The nature of the business of the company is to generate power for the State. The company is installing the power plants on Engineering, Procurement, Construction (EPC) basis on turnkey job. As per this, the company gets the power plant ready in all respects, starting from design and drawing to generation of the power. For this, the company is issuing order to the L-1 bidder in one consolidated amount. Generally, M/s. XYZ and other integrated power plant equipment manufacturers are taking the EPC contract and complete the power plant. The major components of the power plants are engineering drawing and design, civil work, boiler turbine generator and switchyard etc. On the basis of this broad back up, the company is maintaining fixed asset registers plant-wise with major components of the plant and machinery, such as, hydraulic work, plant and machinery, lines & cables and capital spare parts. At the time of purchase, the detailed parts assembled in the boiler and turbine generator etc. cannot be determined. Therefore, the costs of these specific parts are not available. During the continuous operation of the plant, the company is required to maintain annual overhauling (AOH), major overhauling and capital overhauling (COH). As per the requirements of demand and supply of power, shut down of the plant for the AOH and COH is carried out as per the planning of the State requirement and Grid position. During this maintenance period, some parts are replaced by newly purchased spares.

2. The querist has stated that as per the standard practice adopted by all the power generating companies for machineries, whatever be the cost of the capital spare purchased either with plant and machinery or separately, it has to depreciate over balance useful life of plant. In case of replacement of old/worn out parts, the costs of original parts are not available and it is very difficult to ascertain the value of the replaced parts or old parts and depreciation thereon separately. When the parts are removed, these are sold as scrap and shown as other income. Under this situation, deduction from gross block is not possible and therefore, as per the querist, all large scale industries are not deducting cost of worn out parts from the gross block and charge depreciation as it is. This is a globally adopted practice since beginning.

3. The querist has also stated that the learned statutory auditors of the company have qualified the report for the financial year 2014-15, by stating that old capital parts are not charged to revenue in the year in which such parts are replaced. The company is of the view that this is disposable scrap and has no market or negligible value because the part is an asset having a specific machine design. To be more specific, in the ordinary course of life also, suppose the company had purchased a building or computer. Then, in case of replacement of window or key board, it is not possible to ascertain the carrying amount of this window or key board and, hence, its value is not deducted from the original asset. If in ordinary course of activity it is not possible, then in the plant and machinery, boiler turbine etc. is a complex

¹ Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

part and it is impossible to determine specific value/carrying amount of installed parts which is worn out.

B. Query

4. In view of above, the querist has sought the opinion of the Expert Advisory Committee as to whether the practice of non-removing carrying value of worn out parts is appropriate as there is no possibility of determining carrying value of worn out/old parts to be replaced.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to the appropriateness of the practice followed by the company of non-removal of carrying value of worn-out part of a fixed asset replaced by spares. Therefore, the Committee restricts itself to the specific issue raised by the querist and has not examined any other issue that may be contained in the Facts of the Case, such as, appropriateness of rest of the accounting policy of the company related to spares as mentioned in the facts of the case, recognition of the income realised from the sale of old/damaged part that has been replaced as 'other income', etc.

6. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') 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.

7. In the context of Accounting Standard (AS) 10, 'Accounting for Fixed Assets'², notified under the 'Rules', the Committee notes from the Facts of the Case that the querist has stated that as per the standard practice adopted by all the power generating companies for machineries, whatever be the cost of the capital spare purchased either with plant and machinery or separately, it has to depreciate over balance useful life of plant. Therefore, the Committee has presumed that the spares in the extant case can be used only in connection with an item of fixed asset and their use is expected to be irregular in accordance with the requirements of paragraph 8.2 of AS 10 and has not examined whether the spares fulfil the aforesaid requirements of AS 10 or not.

8. Further, in the context of the part/component that is being replaced, the Committee notes from the Facts of the Case that for the financial year 2014-15, the company has considered such part/component as an integral part of the plant which has been capitalised alongwith the cost of the plant itself. In this regard, the Committee also notes the requirements of Note 4 of Schedule II to the Companies Act, 2013, which provide as follows:

“Useful life specified in Part C of the Schedule is for whole of the asset and where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.”

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.

Further, as per the MCA Notification dated August 29, 2014, the said requirement shall be voluntary in respect of the financial year commencing on or after April 1, 2014 and mandatory for financial statements in respect of financial years commencing on or after April 1, 2015. Thus, from the financial year 2015-16, component accounting needs to be followed mandatorily in respect of a part/component of an asset whose cost is significant to the total cost of the asset and where useful life of that part is different from the useful life of the remaining asset. In this regard, the Committee notes from the facts of the case that although it appears that useful life of the part or component that is being replaced is different from the useful life of the concerned plant and machinery, it is not clear as to whether or not cost of such part or component is significant to the total cost of the plant and machinery to which the requirements of 'component accounting' as per the Companies Act, 2013 are required to be applied. Accordingly, the Committee, while expressing its views has considered both the situations, viz., where the component accounting is followed (either voluntarily or otherwise considering the requirements of the Companies Act) and where component accounting is not required to be followed considering the requirements of the Companies Act.

9. In a situation, where component accounting is followed (either voluntarily or otherwise considering the requirements of the Companies Act), the Committee notes the recommendations contained in the Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013, issued by the Institute of Chartered Accountants of India, in respect of component accounting, as reproduced below:

“48. As per note 4 of Schedule II -“Useful life specified in Part C of the Schedule is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.” As per the amendment dated August 29, 2014 notified by the MCA, the said requirement shall be voluntary in respect for the financial year commencing on or after the April 1, 2014 and mandatory for financial statements in respect of financial years commencing on or after April 1, 2015.

49. The above requirement is commonly known as 'component accounting'. Companies will need to identify and depreciate significant components with different useful lives separately. The component approach is already allowed in paragraph 8.3 of the current AS 10. Under AS 10, there seems to be a choice in this matter; however, Schedule II requires application of component accounting mandatorily. The determination as to whether a part of an asset is significant requires a careful assessment of the facts and circumstances. This assessment would include at a minimum:

- Determine the threshold value to determine which asset requires componentisation.
- Threshold value in percentage of cost of component to the total cost of the asset
- Proportion of useful life of that part as compared to the useful life of the asset
- Potential impact on the total depreciation expenditure

50. 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

and accounting for replacement costs. Currently, companies need to expense replacement costs in the year of incurrence. Under component accounting, companies will capitalise these costs as a separate component of the asset and decapitalise the carrying amount of previously recognised component. When it is not practicable to determine the carrying amount of the replaced part, the cost of the replacement may be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed.”

“52. A company is required to apply component accounting (if appropriate) for all depreciable fixed assets (existing or newly acquired) as at 1 April 2014 if a company opts to follow it voluntarily and as at 1 April, 2015 mandatorily. However, if the carrying amount of any asset is lower than or equal to the estimated residual value of the asset(s), company is not required to apply component accounting for such asset(s).”

“54. Further, under component accounting, an issue arises whether the transitional provision under Note 7 of Schedule II will be available to company on April 1, 2015, with respect to componentisation, though it adopted the other provisions (useful life) of Schedule II as on April 1, 2014. This Guidance Note clarifies that if a company determines the life of a component which is different from the remaining asset and such useful life happens to be nil as on the date of transition to Schedule II either on voluntary basis or on mandatory basis as the case may be, the carrying amount of such component may be transferred directly to the retained earnings. In other words, the transitional provisions of Schedule II may be applied *mutatis mutandis* w.r.t. component accounting. Further, if the company opts to adjust the carrying amount of the components to the retained earnings in accordance with the transitional provisions of Schedule II, the tax effect of the same has also to be adjusted directly against the retained earnings in accordance with the Announcement issued by the Institute of Chartered Accountants of India, “*Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account*”.”

From the above, the Committee is of the view that when the component accounting is applied, in the context of the replacement of worn-out/old part or component, the cost of new replaced part shall be capitalised as a separate component of the concerned plant and machinery and the carrying amount of the replaced worn-out part/component shall be decapitalised. As far as the issue of determining the carrying amount of the replaced part is concerned, the cost of the new replaced part may be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed. Further, the company needs to apply transitional provisions under Note 7 of Schedule II to the Companies Act, 2013 from the date it applies component accounting, viz., 1.4.2014 or 1.4.2015 as the case may be. Accordingly, under transitional provisions, the carrying amount of the component whose useful life is nil as on the date of transition, may be transferred directly to retained earnings.

10. In a situation, where component accounting is not required to be followed considering the requirements of the Companies Act, the Committee notes paragraphs 8.2 and 23 of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, notified under the ‘Rules’, which state as below:

“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.”

“23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.”

The Committee notes from the above that at the time of subsequent expenditure, it should be evaluated as to whether the subsequent expenditure increases the future benefits arising from the asset beyond its previously assessed standard of performance in terms of its useful life, or its production capacity, or in terms of decreased operational costs, etc. Applying the above principles, the Committee notes that since the replacement of worn out parts of the fixed asset with new spares, normally does not increase the future benefits arising from the fixed asset beyond its previously assessed standard of performance, the cost of replacement should be charged to the statement of profit and loss and should not be added in the value of fixed asset.

11. With regard to reducing the written down value of the old/ worn-out part that is being replaced from the value of the fixed asset, the Committee is of the view that ordinarily, when a part of the fixed asset gets worn out and is physically replaced by its capital spare, the part taken out from the fixed asset is of no further use and is discarded. The capital spare, which now replaces the original part in the fixed asset loses its separate identity and becomes a part of the fixed asset. Accordingly, on replacement, it is the written down value of the spare (that had been separately capitalised earlier) which replaces the worn-out part that should be written off in the profit and loss account and not the written down value of the worn-out part itself.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that in a situation, where ‘component accounting’ is not required to be followed considering the requirements of the Companies Act, 2013, the practice of not derecognising written down/carrying value of worn-out part in the fixed asset that is being replaced with a spare is appropriate as per the requirements of AS 10, notified under the Rules, as discussed in paragraphs 10 and 11 above. In such a case, the cost of replaced part is charged to the statement of profit and loss (unless it results in increase in future benefits). However, in a situation, where ‘component accounting’ is followed (either voluntarily or otherwise considering the requirements of the Companies Act), the cost of the replaced part shall be capitalised as a separate component of the concerned plant and machinery and the carrying amount of the replaced worn-out part/component shall be decapitalised. As far as the issue of determining the carrying amount of the replaced part is concerned, the cost of the new replaced part may be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed. Further, the company needs to apply transitional provisions under Note 7 of Schedule II to the Companies Act, 2013 from the date it applies component accounting, viz., 1.4.2014 or 1.4.2015 as the case may be. Accordingly, under transitional provisions, the carrying amount of the component whose useful life is nil as on the date of transition, may be transferred directly to retained earnings, as discussed in paragraph 9 above.
