

Query No. 7

Subject: *Accounting policy on depreciation of dredgers and accounting treatment of repair costs during drydock of a dredger after completion of estimated useful life.*¹

A. Facts of the Case

1. A public sector undertaking under the Ministry of Shipping commenced its commercial operations in April, 1977 and since then it has been earning profits. The company is a listed company in the stock exchanges of NSE, BSE, CSE and DSE. The turnover of the company for the financial year (F.Y.) 2014-15 was Rs. 744 crore with an after tax profit of Rs. 62 crore. The company was incorporated with the objective of providing dredging services to major ports, minor ports and other maritime organisations covering both maintenance and capital dredging requirements. As on date, the company possesses 12 trailer suction hopper dredgers, 3 cutter suction dredgers and 1 backhoe dredger.

2. Depreciation was charged on 'dredgers' at the rates specified under Schedule XIV to the Companies Act, 1956 which stipulated minimum rates at which the depreciation is to be charged. The rates fixed for dredgers, tugs, barges, survey launches and other similar ships used mainly for dredging purposes was 7% under straight line method. The company has been charging for depreciation on 'dredgers' at the rate of 7% p.a. upto F.Y. 2013-14. This means that the life of the vessel was considered as 14 years. The remaining 2% {100% - 98% (7% x 14)} was being considered as residual value.

3. The particulars of existing dredgers, month and year of acquisition, original cost of acquisition, and their age are given below:

S. No.	Particulars of Dredger	Date of Commissioning of Dredger	Original cost of Acquisition (Rs. Lakhs)	Present Age as on 31/03/2015 (Years)
1	Dredger-VI	01/01/1976	710.63	39
2.	Dredger-VII	07/09/1977	884.38	38
3	Dredger-VIII	10/05/1976	1693.21	39
4	Dredger-IX	01/01/1984	2469.52	31
5	Dredger-XI	01/01/1986	2732.56	29
6	Dredger-XII	05/10/1990	8872.37	25
7	Dredger-XIV	10/01/1991	8911.48	24
8	Dredger-XV	24/04/1999	9455.19	16
9	Dredger-XVI	01/04/2000	20729.89	15
10	Dredger-XVII	01/08/2001	18200.62	14
11	Dredger-XVIII	21/01/2011	27373.51	4

¹ Opinion finalised by the Committee on 10.5.2016 and 11.5.2016.

12	Dredger-XIX	21/12/2012	64058.17	2
13	Dredger-XX	24/07/2013	60508.50	2
14	Dredger-XXI	10/03/2014	63662.75	1
15	Back-hoe-BH 1	22/11/2011	12954.16	3
16	Dredger Aquarius	1977	6306.52	38

4. As may be observed from the above table, dredgers are available for use by the company for even after 30 years of age and thus have a useful life of more than 30 years. Dredgers VI, VIII, IX, XI, XII, XIV, XV, and Aquarius have been fully depreciated (leaving a residual value of 2% of the cost of the asset) as on date as per the Companies Act, 1956 considering the rate of depreciation as 7% p.a. under straight line method. The dredgers are being economically deployed at various places.

5. The querist has stated that ABC Ltd., Netherlands, the builder of dredgers, issued a certificate dated 14/01/2014 stating that the newly built dredgers, viz., dredger XIX, XX and XXI should have an expected life of over 25 years.

6. The existing accounting policy on depreciation in respect of 'dredgers' has been reviewed/examined keeping in view the changes in the new Companies Act, 2013 read with the Notification of the Ministry of Corporate Affairs dated 31/03/2015, Accounting Standards, certificate issued by ABC Ltd., Netherlands, the builder of dredgers to the effect that the dredgers built by them have a useful life of 25 years and a certificate given by a technical expert. According to the querist, internationally also, dredgers were found to have an average useful life of 30-40 years.

7. It was noted by the company that depreciation charge taking useful life of 14 years can no longer be considered as fair charge when dredgers in fact have a useful life of more than 30 years which is evident from the table shown above. As per the experience of the company, the dredgers are available for use for more than 30 years, whereas the depreciation is getting charged only for initial 14 years and in the later 16 years, there is no charge of depreciation even though the dredger is available for use. In fact, as per accepted practices, 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.

8. Keeping in view the above position of dredgers, the changes in Companies Act, 2013 and other factors as stated in paragraph 6 above, the company revised its accounting policy on depreciation w.e.f. F.Y. 2014-15. The existing accounting policy has been supplied by the querist for the perusal of the Committee.

9. Revised accounting policy on depreciation w.e.f. F.Y. 2014-15 is as under:

“Depreciation is provided considering the useful lives, as prescribed under Schedule II of the Companies Act, 2013, other than the following class of assets, whose useful lives are different from that of the lives prescribed in the Schedule, which are determined based on the technical evaluation.

i. Dredgers –

- (a) the useful life of dredgers will be 25 years.
- (b) Expenditure incurred on dry-docking of dredgers, which have completed the useful life of 25 years already, is capitalised to the said dredger and depreciated over the extended useful life determined by technical evaluation

Note:

Residual value of the dredgers will be considered at 2% of the original cost of the dredger, including capitalisation of exchange variance in accordance with Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates'.

In respect of the following assets, depreciation is provided on straight line method based on technical estimation of useful lives of such assets:

- ii. Pipeline equipment: 25% for mild steel pipeline equipment and 12.5% for high density polyethylene pipeline equipment.
- iii. Second hand assets: As per the estimate of balance service life.
- iv. Buildings on lease: Cost of buildings constructed on lease hold land is amortised over the lease period.
- v. Items of fixed assets whose cost does not exceed Rs. 5000/- each are capitalised and 100% depreciated during the year.
- vi. Cost of Library: Cost of library is considered as other establishment expenditure.
- vii. The exchange differences on long term foreign currency monetary liabilities used for acquisition of specific fixed assets, adjusted to the cost of fixed assets, are amortised over the remaining useful life of the said asset.”

10. During F.Y. 2014-15, the company incurred drydock repair expenses amounting to Rs. 9.74 crores (on dredger-IX – Rs. 8.74 crore and on dredger-XI – Rs. 1 crore), which have completed their originally determined useful life (25 years). As per Indian Register of Shipping (IRS) Rules, all ships classed with IRS are to undergo special surveys at five yearly intervals and at least one intermediate survey has to be carried out between 2nd and 3rd year from the date of completion of special survey. Dredger-IX underwent special survey during this drydock repairs. Accordingly, after the completion of drydock repairs, IRS extended the full term International loadline certificate/ full term cargo ship safety certificate, etc. with validity upto 31/03/2019. As per the technical certificate signed by General Manager (Technical), after completion of the said repairs, Dredger-IX will have an extended useful life of two years. Dredger-IX completed its drydock repairs and the cost of the said repairs amounting to Rs. 8.74 crores has been added to the cost of the Dredger-IX and the amount for the proportionate period after completion of the

said drydock repairs i.e., 1/08/2014 to 31/03/2015 amounting to Rs. 2.91 crores was charged to depreciation. In the case of Dredger-XI, an amount of Rs. 1 crore spent was shown as work-in-progress pending completion of drydock repairs which is expected to extend the life beyond the originally stated life by a minimum of another two years.

11. CAG audit has commented on the above accounting treatment as under:

“Repairs and Maintenance (Vessels) – Rs. 69.35 crore

13) This includes Rs. 9.74 crore towards the dry dock of dredgers IX and XI. While furnishing reply to Audit Note – 6, the management stated that based on the Technical Certificate, after completion of above said repairs, the life of Dredger IX stood extended for two years from the date of completion of its repairs. So, the cost of repairs amounting to Rs. 8.74 crore will be added to the cost of the asset and proportionate amount attributable to 1-8-2015 to 31-03-2015 i.e., Rs. 2.91 crore will be charged to depreciation for F.Y. 2014-15. Likewise in the case of Dredger XI, since the dredger is still to complete its repairs, the amount spent i.e., Rs. 1 crore during the F.Y. 2014-15 will be shown under capital work-in-progress. Thus, the management intended to withdraw the repair expenditure of Rs. 9.74 crore and debited to assets.

The reply of the management is not tenable in view of the following:

- A. The dry-dock expenditure is a regular maintenance expenditure to restore the dredger to normal conditions and it is purely a revenue expenditure. The dry dock expenses and cost of replacement of spares etc. during the dry dock are against the wear and tear suffered by the dredger and to bring the vessel into normal working condition. Hence, treating the dry dock expenses as capital expenditure for short period and that too for two years is not correct.
- B. As per paragraph 12.1 of AS 10², only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. The dry dock repairs will not increase original capacity of the dredgers except to optimally restore the dredger to its original capacity.
- C. As per corporate policy, retrofit of dredgers is of capital nature and the management intended to capitalise the expenditure under deferred revenue expenditure. Thus, treating the ordinary routine dry dock as capital expenditure is not correct.
- D. As per the accounting policy of another company, XYZ, in the industry, the dry dock expenses are charged to profit and loss account and not to capital.

² Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’ 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.

Reversing the entries by the company, resulted in understatement of repairs and maintenance (Vessels) by Rs. 9.74 crore, overstatement of fixed assets by Rs. 8.74 crore, capital work in progress by Rs. 1.00 crore and depreciation for the year by Rs. 2.91 crore. Consequently, the profit for the year is overstated by Rs. 6.83 crore.”

12. The company replied as under:

“As per the accounting policy approved by the Audit Committee and the Board:

“Expenditure incurred on drydocking of dredgers which have completed the useful life of 25 years already is capitalized to the said dredger and depreciated over the extended life determined by technical evaluation.”

Dredgers IX and XI have completed their life of 25 years. In accordance with the above policy and based on the technical certificate, after completion of above said repairs, the life of Dr. IX stood extended for two years from date of completion of its repairs. So, the cost of repairs amounting to Rs. 8.74 crore was added to the cost of the asset and proportionate amount attributable to 1-8-2015 to 31-03-2015, i.e., Rs. 2,91,29,927 was charged to depreciation for F.Y. 2014-15.

In the case of Dredger XI, the dredger is still to complete its repairs and therefore, the amount spent, i.e., Rs. 1 crore for F.Y. 2014-15 was shown under capital work-in-progress.

(A & B) In the cases of Dredger IX and XI, both have completed their originally stated life. So the present expenditure is to enhance its originally estimated life and make use of vessel for two more years. In other words, originally estimated 25 years has been enhanced to two more years. Hence, this meets the requirement of AS 10.

(C) The expenditure incurred for making use of the asset beyond its originally stated life (i.e., 25 years) is to be capitalised and is to be depreciated over its estimated extended life. This treatment is as per AS 10. The expenditure incurred would result in the asset becoming useful for two years.

(D) Any expenditure incurred resulting in increase of originally estimated life or standard of performance etc. is capital expenditure. All other drydock repair expenses which did not meet this criterion were charged to revenue.

There is no overstatement of profit/fixed assets etc. as stated by Audit. In view of above clarifications and that since the treatment is in line with the Accounting Policy No. 5 of the company and also in accordance with AS 10, the Audit is requested to drop the observation.”

13. Statutory auditors agreed with the company’s reply. During the course of subsequent discussions with CAG audit, the CAG audit dropped their comments subject to an assurance that

the company shall refer the matter to the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) on the issue as to whether the accounting treatment made by the company with regard to dry dock expenses incurred in respect of Dredger-IX and Dredger-XI is in order.

B. Query

14. In the above background, the querist has sought the opinion of the Expert Advisory Committee on the issue as to whether the accounting treatment made by the company with regard to repair expenses incurred during dry dock, as referred to by the CAG audit, incurred in respect of Dredger-IX and Dredger-XI is in order.

C. Points considered by the Committee

15. The Committee notes that the basic issue raised in the query relates to accounting treatment made by the company with regard to repair expenses during dry dock, as referred to by the CAG audit, incurred in respect of Dredgers IX and XI, which have already completed their originally estimated useful life of 25 years. 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 policy in respect of other dredgers and various equipments/fixed assets of the company, accounting for exchange variation on long term foreign currency monetary liabilities used for acquisition of specific fixed assets, accounting for cost of special survey and intermediate survey as a separate component, etc. 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.

16. The Committee notes from the facts of the case that the company incurred dry dock repair expenses on dredger IX and XI during F.Y. 2014-15, by which these dredgers have already been used for 30 and 28 years respectively. Further, the costs of these assets (less residual value) have already been depreciated in full over 14 years as per the rates prescribed in the Companies Act, 1956. Accordingly, as on 1.4.2014, when Schedule II of the Companies Act, 2013 came into effect, only the residual value of these dredgers was appearing as the carrying amount in the books of account. In this regard, the Committee further notes the requirements of Note 7 to Schedule II to the Companies Act, 2013 as follows:

“7. From the date this Schedule comes into effect, the carrying amount of the asset as on that date—

(a) shall be depreciated over the remaining useful life of the asset as per this Schedule;

(b) after retaining the residual value, may be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil.”

From the above, the Committee notes that Schedule II requires companies to re-estimate the remaining useful life of the existing assets as per the requirements of Schedule II and give effect to the revision in the useful life of the assets in accordance with the above requirements. With regard to the revision in useful life, the Committee further notes paragraph 23 of Accounting Standard (AS) 6, 'Depreciation Accounting'³, notified under the Companies (Accounting Standards) Rules, 2006 as follows:

“23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.”

From the above, the Committee notes that AS 6 requires that in case of revision in the useful life of a depreciable asset, it is the unamortised depreciable amount that should be charged over the revised remaining useful life. From this it implies that on the date of revision in the useful life of the asset, the depreciable amount (which is historical cost/revalued amount less residual value) should be in existence. Since in the extant case, costs of Dredgers IX and XI (less residual value) have already been depreciated in full, no unamortised amount is left as on the date of Schedule II coming into effect. Accordingly, the Committee is of the view that the question of allocating the unamortised depreciable amount over the revised remaining useful life as per the requirements of the Schedule II and AS 6 does not arise.

17. The Committee further notes from the Facts of the Case that as per Indian Register of Shipping (IRS) Rules, all ships classed with IRS are to undergo special surveys at five yearly intervals and at least one intermediate survey has to be carried out between 2nd and 3rd year from the date of completion of special survey. Thus, dry dock expense is a periodical and regular maintenance expenditure which has to be incurred on regular intervals over the life of the dredgers. The Committee is of the view that the fact that the dredgers have to undergo such kind of regular maintenance is known to the company from the very beginning when the dredgers are put to use and when their useful life is determined. Therefore, the useful life of the dredgers should be estimated after taking into consideration such periodical and regular maintenance. Thus, once the useful life is determined considering the periodical maintenance, the question of increase in the useful life due to regular and periodical maintenance, such as, dry docking does not arise. For example, a plant and machinery may have different useful life depending upon whether the regular maintenance expenditure required on regular intervals for the smooth functioning of such plant and machinery is carried out or not and if an entity intends to carry out such regular maintenance, the useful life of the plant and machinery should be estimated taking into consideration such regular maintenance.

³ The opinion should be read in the context of Accounting Standard (AS) 6, 'Depreciation Accounting'. However, it may be noted that the Standard has been withdrawn 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.

D. Opinion

18. On the basis of the above, the Committee is of the opinion on the issue raised in paragraph 14 above that the accounting treatment followed by the company of (i) capitalising the repair expenses, as referred to by the CAG audit, incurred during dry dock in respect of Dredgers IX and XI, whose depreciable amounts have already been written off in full to the value of such assets and (ii) depreciating the same over the revised remaining useful life is not appropriate for the reasons discussed in paragraphs 16 and 17 above.
