

## Query No. 8

**Subject: Accounting treatment of revaluation of 'Regeneration expenses' - Inventories.<sup>1</sup>**

### A. Facts of the Case

1. A company (hereinafter referred to as the 'company') is engaged in improving the productivity of forest areas transferred to it by the forest department of the state by raising plantations and carrying out silvicultural activities. The company is predominantly engaged in the selling of forest produce (termed as Crop-I and Crop-II) that has been obtained from the silvicultural exploitation operation in the forest areas. The difference between the two crops is stated below:

- (a) **Crop-I:** Forest areas are transferred by the Forest Department, Government of Madhya Pradesh (GoMP) to the company. At the time of transfer of these forest areas, all the forest produce that was initially present in these forest lands is silvicultured by the company as per the approved guidelines, under scientific methods of forestry and approved working plans from the Government of India (GOI). After silvicultural operations of these transferred forests, the forest produce that is reaped, i.e., teakwood etc. is sold by the company on behalf of Forest Department, Government of Madhya Pradesh. After deducting the direct and indirect expenses from the revenue received by selling these forest produces, the net revenue is given to Forest Department, GoMP as 'Lease Rent'. On the total sale of this forest produce, i.e., Crop I, the company receives 2% commission from the GoMP. Hence, basically, Crop I is the revenue generated from the standing crop that is sold by the company on behalf of the Forest Department, GoMP from the areas transferred to the company.
- (b) **Crop-II:** The company raises plantations on these exploited forest areas. These plantations will mature for harvesting only after around 60 years of plantation in case of teak. Meanwhile, scientific silvicultural operations, namely, nursery preparation, spacing, pruning, thinning etc. are periodically performed on these growing plantations, which yield substantial forest produce and such thinning operations generate substantial revenue. Thinning operations are performed in the 11<sup>th</sup>, 16<sup>th</sup>, 21<sup>st</sup>, 26<sup>th</sup>, 31<sup>st</sup>, 36<sup>th</sup>, 41<sup>st</sup> and 46<sup>th</sup> year of plantation in case of Teak and every 4<sup>th</sup> year in case of Bamboo. These forest produces are being sold by the company and the revenue generated is mentioned as the revenue generated from Crop II in the final accounts of the company. The entire amount received by the company by the sale of such silviculture operation periodically is called as Crop II. Crop II is basically the crop generated by the company after clear felling in the areas transferred to the company year after year against its own plantation done in the previous years. Amount generated from the sale of Crop II fully pertains to company's revenue and nothing is paid to GoMP against the revenue so generated.

The 'net income' arising out of sale of Crop-II (i.e., sale of forest produce grown by the company) is exempt from income tax being '*Agricultural Income*'. The company is carrying out above operations through its 11 divisions situated in various districts of the State of Madhya Pradesh.

2. The raised plantations are planted and nurtured by the company. All the expenses,

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<sup>1</sup> Opinion finalised by the Committee on 17.3.2017.

i.e., both direct and indirect (preparation of nurseries, plantation, weeding, fire protection and other indirect expenses) are incurred by the company. All the expenses are shown in the balance sheet under 'Current Assets- Inventories-Regenerations expenses' as per the original input cost of Crop II. At the time of final felling of these plantations, i.e., Crop II, all the expenses, i.e., direct and indirect expenses shall be proportionately deducted from the net revenue realised in those areas of clear felling which shall be finally termed as the revenue on sale of Crop II and shall be shown in the balance sheet as sale of Crop II.

3. The querist has stated that as per the accounting policy consistently adopted by the company, the expenses incurred on plantation/regeneration in areas transferred to the company are being depicted under the head 'Regeneration expenses- current assets-inventories' in the balance sheet of the company and are duly disclosed in the 'Notes to the accounts' every year. Though, the method of computation of 'regeneration expenses' and depiction thereof in the accounts is being consistently followed by the company since last several years, yet such depiction does not reflect the 'present value' of these assets. Thus, the above assets of the company are shown in the audited accounts at a substantially suppressed value as compared to its present value. Consequently, the actual 'net worth' of the company is not appearing in the audited accounts. Present book value of standing crop 'regeneration expenses' as on 31/03/2014 as per the audited accounts of the company is Rs. 113.38 crore, whereas the present market value of these assets (inventories) is several times their book value, i.e., about Rs. 3,500 crore. The paid up equity capital of the company is Rs. 39.32 crore and, along with reserves of Rs. 183.13 crores, its net worth as on 31/03/2014 is Rs. 222.44 crore, whereas, the plantations raised by the company alone are valued at more than Rs. 3,500 crore.

4. The querist has further stated that about 7000 hectare area of one of the divisions, Rampur-Bhatodi Project Division, Betul has recently been transferred to Satpura Tiger Reserve, Govt. of Madhya Pradesh. The valuation for this transferred area came to Rs. 1,293.00 crore on the basis of current net market value (market value of standing crop – expenses on exploitation). The company sells its produce in open auctions; hence the valuation of forest produce done on this basis reflects its true market worth. The company has raised around 2,75,000 hectare plantations since its inception. Thus, one can imagine the true market worth of the total plantations raised by the company. The querist has also separately informed that there is no established practice in the company for the valuation of crop of teak and bamboo plantations at net realisable value. Although for fixation of selling price of its forest produce, there is a well established practice for determining the upset price twice a year (in April and October) which is based on the average sale price obtained during the previous 12 months. Further, there is no homogeneous market available in case of forest produce and there is no substitute for teak log, poles, bamboo, fuel etc. because these are natural products and are specific/ specified by nature. According to the querist, there is also no established practice in India or any Accounting Standard issued by the ICAI for valuation of standing crops.

5. The querist has also stated that in its 40 years of existence, the company has pioneered in raising of successful plantations and wishes to utilise its expertise by expansion and diversification of its activities, for which the company would require massive low-cost funds. The company wishes to raise these funds via instruments, like Capital Gain Bonds or Infrastructure Bonds. Since the plantation projects undertaken by the company are typically of long gestation periods, bank finance would not be a very feasible option. If the company can show its true net worth by revaluing its 'regeneration expenses' to its present worth, it can leverage it to obtain such funds. The company thus

intends to revalue its 'regeneration expenses' by depicting the same as its 'real asset value' and increase its net worth by the like amount.

## **B. Query**

6. Based on the above facts, the querist has sought the opinion of the Expert Advisory Committee regarding the validity of:

- (a) Accounting treatment of the proposed revaluation of 'Regeneration Expenses' with reference to Crop-II;
- (b) Disclosure requirement in respect of proposed revaluation having regard to the Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI) and provisions of the Companies Act, 2013.

## **C. Points considered by the Committee**

7. The Committee, while answering, has considered only the issues raised in paragraph 6 above and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment in respect of Crop I, accounting for various expenses booked as regeneration expenses under inventory, calculation of net worth of the company, etc.

8. The Committee notes that in the extant case, all the expenses, direct or indirect (such as preparation of nurseries, plantation, weeding, fire protection and other expenses), incurred by the company for raising standing crops in respect of Crop II are being accounted for as 'regeneration expenses' under inventories. Now, the company is proposing to revalue these regeneration expenses/inventory of the standing crops, at its present worth/real asset value based on their market value. In this regard, the Committee notes the following paragraphs of Accounting Standard (AS) 2, 'Valuation of Inventories', notified under Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'the Rules').

***"1. This Standard should be applied in accounting for inventories other than:***

...

- (d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries."***

***"2. The inventories referred to in paragraph 1 (d) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard."***

The Committee notes from the above that AS 2 is not applicable to producers' inventories of *agricultural and forest products* to the extent that they are measured at net realisable value in accordance with well established practices in those industries. The Committee is of the view that the scope exclusion paragraph 1 (d) of AS 2 deals with the agricultural products which are the harvested produces and not standing crops and therefore, the plantations in the extant case do not fall in the scope exclusion paragraph 1 (d) of AS 2, notified under the Rules. Accordingly, the 'regeneration expenses' with reference to Crop II should be valued at the lower of historical cost and net realisable value as per paragraph

5 of AS 2, as reproduced below:

**“5. Inventories should be valued at the lower of cost and net realisable value.”**

The Committee further notes the following paragraph from ‘Chapter V- Valuation of Assets’ of the Monograph on Accounting for Agricultural Operations, issued by the Research Committee of the ICAI:

“General Principles:

...

- 3) *Standing Crops:* The standing crops in a farm are similar to the work-in-progress in manufacturing industries and the general accounting principles of valuation of work-in-progress would be applied for standing crops. Thus, the standing crops would be valued at the lower of cost and net realizable value. The latter would be ascertained after making allowance for the expenses yet to be incurred to make the crop marketable and the marketing expenses. It may be mentioned that innumerable natural risks are associated with the agricultural operations and it would be prudent to carefully assess and provide for these risks while valuing the standing crops.”

On the basis of the above, the Committee is of the view that the inventories of standing crops in the extant case should be valued at the lower of cost and net realisable value and accordingly, the proposed revaluation of the regeneration expenses is not correct.

#### **D. Opinion**

9. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 6 above:

- (i) The proposed revaluation of ‘regeneration expenses’ with reference to Crop II is not correct as discussed in paragraph 8 above.
- (ii) In view of (i) above, question does not arise.

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