

Query No. 13

Subject: *Classification of spares.*¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the company’) was incorporated on 2nd April 1976 as the country’s prestigious 100% Export Oriented Unit (EOU) with head quarter at Bengaluru, Karnataka and was originally engaged in the mining and beneficiation of low-grade magnetite ore into high grade iron ore concentrate and export of the same. Subsequently, as per the Supreme Court Order, mining operation and beneficiation at XYZ mine site was stopped with effect from 01.01.2006.

2. At present, pelletisation and blast furnace units of the company are in operation at its Mangaluru establishment. The company is having facilities to operate 3.5 metric tonnes per annum (MTPA) iron-oxide pellet plant, blast furnace unit to manufacture 2.16 lakh tons per annum pig iron at Mangaluru. In view of the iron ore being sold in Karnataka only through e-auction mode as per the Supreme Court’s order, the input, hematite iron ore fines, as raw material for the manufacture of pellets and iron ore lumps for pig iron, is being procured mainly from Bailadila sector of one of the public sector undertakings, through road (railway rakes) cum sea route. Efforts are also on to procure iron ore from other sources including imported sources. The pellets are exported and also sold in the Domestic Tariff Area (DTA) market.

3. As a part of its operations, the company procures stores and spares from time to time and is maintaining the stock of spares in anticipation of requirement at any time during operation of the plant. Upto the financial year 2016-17 till the adoption of Ind AS, these spares were classified as ‘Inventory’.

4. During the financial year 2017-18, the company reviewed stock of all the stores and spares based on their usage, quality and present physical condition. A technical committee was constituted to examine all the stores and spares and to recommend about their usability, retention as ‘Inventory’ etc. The Committee after reviewing all the items of stores and spares, recommended that the spares worth Rs. 1,331.43 lakhs as on 31.03.2018 which are directly attributable to any particular plant & machinery should be classified as ‘capital spares’, thereby segregating these from normal inventories, towards better disclosure. Based on the said technical assessment, Spares usable only for any particular plant & machinery were categorised as ‘capital spares’ and were disclosed in the financial statements separately under the head ‘Inventory’. The total value of spares consumed during the financial year were charged off as expenses.

5. From the financial year 2015-16, the Companies Act, 2013 mandated application of ‘Component Accounting’ whenever relevant and material. As per Note 4 of Notes to Schedule II to the Companies Act, 2013:

“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.”

Thus, as per the querist, under ‘Component Accounting’, companies will need to identify and depreciate significant components with different useful lives separately. The querist has

¹ Opinion finalised by the Committee on 21.11.2019.

mentioned in this context that the spares mentioned above cannot be classified as 'Component' as per the above criteria of 'Component Accounting'.

6. Further, the querist has stated that there is no specified useful life of these spares and these are not frequent in usage. The use of these spares towards replacement of damaged/broken down parts of the relevant plant and machinery is not likely to increase the future benefits from the said plant and machinery. Whenever spares are used to replace any parts, the useful life of the original plant and machinery does not change. The removed parts are sold as scrap in the normal course of business.

7. The company followed the said practice during the subsequent financial year 2018-19 also as per the principle of consistency. Accordingly, as on 31.03.2019, capital spares worth Rs. 1,093 lakh (634 items, list supplied by the querist for the perusal of the Committee) was disclosed as a separate line item as 'Capital Spares' under the head 'Inventory' in the financial statements for the financial year 2018-19.

8. During the audit of annual accounts for the said year, Director General of Commercial Audit (CAG) has made the observation that there was incorrect classification of capital spares under the head 'Inventories'. The same should be classified under 'Property, Plant and Equipment' as per the provisions under paragraphs 7 and 8 of Ind AS 16, 'Property, Plant and Equipment'.

9. Provisional Comments of CAG

"Inventories (Note 7.a) Rs. 30886.63 Lakh

The above is overstated by Rs.1093.00 Lakh due to incorrect classification of Capital Spares under inventories instead of classifying the same under Property, Plant and Equipment (Note 3.1) as per the provisions under para 7 and 8 of Ind AS 16 Property, Plant and Equipment. Further, as per the Accounting Policy no 1.12 on Inventories, "Capital Spares are valued at Cost". The same is also not in line with provisions of Ind AS 16 Property, Plant and Equipment. This has also resulted in understatement of Property, Plant and Equipment (Note 3.1) by Rs.1093.00 Lakh and non-compliance to the provisions of Ind AS 16 Property, Plant and Equipment. The impact on account of depreciation could not be quantified due to non-availability of data."

10. Reply given by the company to CAG:

"During the year Capital Spares amounting to Rs. 1,093.00 Lakh (Previous Year Rs. 1,331.43 Lakhs) are classified as Capital Spares and shown in the Balance Sheet as "Inventories". As per Ind AS 16, property, plant and equipment are tangible items that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (b) are expected to be used during more than one period.

These Spares to be used for maintenance of assets, stand-by equipment and life of spares cannot be ascertained. Accordingly, Capital Spares/Stand by Equipment is not Property, Plant and Equipment.

As per paragraph 8 of Ind AS 16 "Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as Inventory."

As Capital Spares are not Property, Plant and Equipment, meant for use as servicing equipment and charged to revenue in the year of use, classified under 'Inventory'."

11. The querist has stated that CAG after perusal of reply given by the company, decided to retain their observation under section 143(6)(b) of the Companies Act, 2013 on the accounts of the company for the year ending 31st March, 2019. Since the company differed with the comment given by CAG, it was decided that the issue would be examined during the financial year 2019-20 by external consultants/professional bodies like Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI). Based on the opinion obtained from such external experts, the appropriate accounting adjustment if required would be made in the books of account.

B. Query

12. In view of the above, the querist has sought the opinion of the Expert Advisory Committee of the ICAI on the following issues:

- (a) Whether the practice followed by the company to classify such spares as ‘capital spares’ and disclosed as separate line item under ‘Inventories’ under the head ‘Current Assets’ is correct.

or

- (b) Such capital spares should be classified under ‘Property, Plant and Equipment’ as commented by CAG.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised in the query relates to classification of spares worth Rs. 1093 lakhs as ‘Inventory’ or ‘Property, Plant and Equipment’ in the books of account of the company. 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, accounting for transition to Indian Accounting Standards, depreciation on spares if these qualify as ‘property, plant and equipment’, accounting treatment of any other item of property, plant and equipment or inventory, component accounting, etc. The Committee wishes to point out that the opinion expressed hereinafter, is in the context of Indian Accounting Standards (Ind ASs), notified under Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time. At the outset, the Committee wishes to point out that the querist has classified some spares as ‘capital spares’ under the head ‘Inventory’, which term is no longer used under Ind AS Framework; therefore the Committee has not examined the appropriateness of using such term and also the said classification made by the company. Accordingly, the opinion expressed hereinafter, covers all types of spare parts, as covered under the Ind AS framework.

14. With regard to accounting for spares, the Committee notes the following requirements of Ind AS 16, ‘Property, Plant and Equipment’:

“Property, plant and equipment are tangible items that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and**
(b) are expected to be used during more than one period.”

“7 The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

- (a) it is probable that future economic benefits associated with the item will flow to the entity; and**
(b) the cost of the item can be measured reliably.

- 8 Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.
- 9 This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.
- 10 An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. The cost of an item of property, plant and equipment may include costs incurred relating to leases of assets that are used to construct, add to, replace part of or service an item of property, plant and equipment, such as depreciation of right-of-use assets.”
- “12 Under the recognition principle in paragraph 7, an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the ‘repairs and maintenance’ of the item of property, plant and equipment.
- 13 Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a nonrecurring replacement. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard (see paragraphs 67–72).”

From the above, the Committee notes that spare parts are recognised as an item of property plant and equipment only if they meet the definition of property, plant and equipment otherwise, these are classified as Inventory. The Committee further notes that as per the requirements under Ind AS 16, for the purpose of classification of spares as ‘inventory’ or ‘property, plant and equipment’, one has to determine the nature of the spares and the purpose for which these are held; and the useful life of the spares. As far as nature and purpose is concerned, the company should first identify whether the spares are small parts which are required for day-to day servicing or repairs and maintenance of an item of property, plant and equipment (PPE) or whether these are held for replacement of significant components of PPE. If these are acquired for day-to-day servicing or repairs and maintenance, these should not be recognised in the carrying amount of the PPE. Further, a judgement is required in applying the recognition criteria to an entity's specific circumstances and sometimes it may be appropriate to aggregate individually insignificant items and to apply the recognition criteria to the aggregate value. Accordingly, in the extant case, the company should evaluate the

nature of the spare parts and the purpose for which these are acquired or held. On the basis of such evaluation, if these spares are not for day-to day servicing or repair and maintenance, and if they meet the definition of PPE, these should be classified as property, plant and equipment', assuming that their cost can be measured reliably. Further, the company should also evaluate whether in the facts and circumstances of the company, it is appropriate to aggregate these spares which are not individually significant (considering the aggregate value in relation to the overall related assets for which these are to be used) and apply the recognition criteria to the aggregate value.

15. As far as useful life is concerned, the Committee notes that the querist has stated that there is no specified useful life of the spares and that the life of spares cannot be determined. In this context, the Committee wishes to mention that the useful life of a spare part is normally linked to the useful life of the asset/part for which it is kept and may be determined on the basis of its frequency of replacement. Thus, howsoever long or short it may be, the company should determine the useful life of the spares. If the spares are expected to be used for more than one period, then, assuming that their cost can be measured reliably, the same should be classified as 'Property, Plant and Equipment'; otherwise, such items should be classified as 'inventory'.

D. Opinion

16. On the basis of the above, the Committee is of the opinion that the company should evaluate in its own facts and circumstances the nature of the spares and the purpose for which these are held; and determine the useful life of the spares, as discussed in paragraphs 14 and 15 above. On the basis of such evaluation, if these spares are not for day-to day servicing or repairs and maintenance and if they meet the definition of 'Property, plant and equipment', these should be classified as 'Property, plant and equipment', assuming that their cost can be measured reliably. Further, the company should also evaluate whether in the facts and circumstances of the company, it is appropriate to aggregate these spares which are not individually significant (considering the aggregate value in relation to the overall related assets for which these are to be used) and apply the recognition criteria to the aggregate value.