

Query No. 30

Subject: *Measurement of residual value of Property, Plant and Equipment/Intangible Assets as a percentage to 'Original Cost' as mentioned in the Companies Act vs. 'Deemed Cost' referred to in Ind AS 101.*¹

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') is a public limited company registered under the Companies Act, listed in Stock Exchanges and thereby governed under the relevant Regulations. It is a maharatna public sector undertaking under the administrative Ministry of Petroleum and Natural Gas, Government of India and is engaged in the business of refining and marketing of petroleum products. By virtue of Government Company, its audited financial statements for a financial year are subjected to supplementary audit under section 143(6) of the Companies Act, 2013 by the Comptroller and Auditor General of India (C&AG).

2. The querist has stated that during the supplementary audit by the C&AG for the financial year (F.Y.) 2019-20, the accounting treatment followed in the Company's books of account with respect to appropriateness of consideration of 'residual value', more particularly, with respect to linking of it to 'Historical Cost', in place of 'Deemed Cost' came up for audit scrutiny. In line with the assurance given to C&AG that the matter would be referred to Expert Advisory Committee of Institute of Chartered Accountants of India, the querist has sought the extant opinion.

3. Until the financial year 2015-16, the Company's accounts had been prepared under the then prevailing Generally Accepted Accounting Principles (IGAAP) and pursuant to introduction of Indian Accounting Standards (Ind ASs), the Company's books of account for financial year 2016-17 was drawn for the 1st time under Ind AS, duly recasting the previous year's figure for financial year 2015-16 under these Standards. By virtue of specific provision under Ind AS 101, First-time adoption of Indian Accounting Standards that permits exemptions during transition, the Company has availed the exemption to continue with the carrying value for all of its property, plant and equipment and intangible assets as recognised in the financial statements as on the date of transition to Ind AS, i.e., 1st April, 2015.

4. As on March 31, 2015, the Company's property, plant and equipment (PPE) and intangible assets, together were stated at a cost of Rs. 48,175 crore and written down value of Rs. 29,063 crore. By virtue of adopting 'Deemed Cost' in reporting PPE/intangible assets in the financial statements, the said written down value was considered to be deemed cost under the transition provision as stated above. Over the years, the Company has been consistently estimating 5% of cost (original cost or historical cost) of assets as its residual value, unless there are assets that could be considered even at a lower valuation. The carrying value of depreciable asset, being the cost of an asset less its residual value, is being depreciated over the useful life of the assets.

5. In the financial year 2019-20, in case of 'LPG Cylinders and Pressure Regulator' (one of the PPE having useful life of 15 years), the 'residual value' was revised on account of change in

¹ Opinion finalised by the Committee on 18.1.2021 to 20.1.2021.

accounting estimate by the management from existing 5% of historical cost to 15% of historical cost. The revision and consequential disclosure is in compliance with the requirements of Schedule II of Companies Act, 2013 (As per Part A, paragraph 3).

6. In this regard, C&AG has expressed a view that in the backdrop of the Company having adopted deemed cost as cost pursuant to adoption of Ind AS, such residual value should have been fixed by the Company as a percentage of deemed cost of PPE. They have further stated that, by virtue of the Company, continuing to keep residual value as a percentage of historical cost of PPE, depreciation charge for the financial year 2019-20 has been understated.

7. According to the querist, the view of C&AG (i.e. *residual value shall be a percentage of deemed cost* of PPE) is considering inter alia, the following:

- i. Under the provisions of Ind AS 101, a first-time Ind AS adopter was allowed to elect to continue with the carrying value of all of its PPE as at the date of transition measured as per the previous GAAP and use that as its deemed cost on the date of transition.
- ii. The term deemed cost has been defined in Appendix A of Ind AS 101 as an amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.
- iii. By virtue of having applied the transitional provision during first time adoption, the view of C&AG is that the change in residual value should not have been measured on the historical cost of the 'cylinders & pressure regulators' which was capitalised before Ind AS period, but should have been on deemed cost adopted on the date of transition (1st April 2015) to Ind AS.
- iv. During discussions over the Provisional Comments issued on the Company's financial statements for the year 2019-20, a view was expressed by the Government Auditors that:
 - a) The Accounting Standards Board of the ICAI has issued a Frequently Asked Question (FAQ) on deemed cost of Property, Plant and Equipment under Ind AS 101, *First-time Adoption of Indian Accounting Standards*;
 - b) The said FAQ contains following reference:

“... As per the definition of deemed cost, it is the amount used as a surrogate for the cost or depreciated cost and for the purpose of subsequent depreciation or amortisation, deemed cost becomes the cost as the starting point...”
 - c) Accordingly, deemed cost is the cost and drawing reference from the said FAQ, Government Auditor's view was that historical cost of PPE is no more relevant once 'Deemed Cost' is adopted by the entity.

8. The Company, however, is of the following view:

(i) The “residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset...” (Paragraph 6 of Ind AS 16, Property, Plant and Equipment). Thus, ‘residual value’ is an absolute value (amount) and need not have any nexus to the historical cost or deemed cost of the asset. Nevertheless, for ease of measurement, it is linked as a percentage of historical cost, which aspect finds support in the Companies Act, 2013. Paragraph 5² of Notes to Schedule II of Companies Act, 2013 states as under:

“5. Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value. Ordinarily, the residual value of an asset is often insignificant but it should generally be not more *than 5% of the original cost of the asset.*”

Further, paragraph 3(i)³ of Schedule II specifies as follows:

“(i) In case of such class of companies, as may be prescribed and whose financial statements comply with the accounting standards prescribed for such class of companies under section 133 the useful life of an asset shall not normally be different from the useful life and the residual value shall not be different from that as indicated in Part C, provided that if such a company uses a useful life or residual value which is different from the useful life or residual value indicated therein, it shall disclose the justification for the same.”

(ii) It is brought to the attention of the Committee that management, having determined residual value based on the actual realisation of similar assets, has linked the same as percentage of original cost for ease of measurement which is in compliance with the Companies Act, 2013. Further, having chosen residual value as a percentage of original cost, the same has been adequately disclosed vide Note 3, sub-note 10 under Property, Plant and Equipment, as under:

“Includes reduction in depreciation for the year by ₹ 127.60 Crore (2018-19: NIL) in respect of LPG cylinders and pressure regulators, arising pursuant to change in accounting estimate over increase in residual value from *5% to 15% of Original Cost effective 01.04.2019.* The revised estimate is based on historical data.”

(iii) Notwithstanding the contention that the manner of accounting is correct and appropriate, even if the calculation of residual value were benchmarked to ‘Deemed Cost’, the quantum of residual value of PPE, continuing to be the same, the percentage of residual value, as a factor of ‘deemed cost’ would only get revised.

(iv) The concept of deemed cost is in vogue since implementation of Ind AS, effective from 01/04/2015. Over the last 4 years, since then, the Company has been consistently computing the depreciation charge by reference to carrying value of assets as reduced by residual value, which is linked to original cost. Thus, there has not been any change in the

² This was omitted wide Notification No. GSR 237(E) dated 31.03.2014.

³ This was substituted wide Notification No. GSR 237(E) dated 31.03.2014.

facts of the case except for revision in accounting estimate of residual value of a particular class of PPE during the financial year 2019-20.

(v) If the Company were to fix residual value as a percentage of deemed cost for a portion of its PPEs/intangible assets, the Company will also have to fix another residual value for the same class of assets, as a percentage of historical cost for the rest of PPE/intangible assets capitalised during Ind AS period. Whereas, having 2 sets of residual value, one quantified as a percentage of deemed cost (pre Ind AS assets) and another, quantified as a percentage of historical cost (Ind AS period assets) is not envisaged in Companies Act/Ind AS. It would also be an administrative nightmare for implementation of the same in the Company's ERP system besides leading to multiple disclosures, thus complicating the understanding of readers of the financial statements.

(vi) The estimation of residual value of an asset need not have any nexus with the cost or deemed cost for the purpose of requirement of Ind AS. The oil marketing companies (OMCs) have fixed the residual value of LPG cylinders and pressure regulators, based on the actual realisation (historical data) of similar assets and for ease of measurement and linked the same as percentage to 'Original Cost' which is well established in Schedule II to Companies Act also.

(vii) The querist has stated that to his best knowledge, there are no explicit provisions in the Companies Act/Ind AS that warrants linkage of residual value to deemed cost. Further in the management's view, as long as depreciation charge for the period is computed in a manner whereby systematic allocation of depreciable amounts over the useful life of the asset is ensured and the same is consistently followed, it is immaterial as to how residual value of an asset be measured, i.e., substance overriding form.

(viii) If the contention of Government auditors were to be correct, then, linking residual value to deemed cost would not only be restricted to 'LPG Cylinders and Pressure Regulators' (wherein management estimate of residual value was changed during the financial year 2019-20 from 5% to 15%), but *on entire fixed assets* of the Company that are carried in the books at deemed cost. It may be noted that the entity has been consistently computing the depreciation by systematically allocating the cost of assets less its residual value over the useful life of the asset.

(ix) Accordingly, it was replied by the Company during issuance of Provisional Comments for the financial year 2019-20 that linking of residual value to a percentage of original cost is appropriate and thus, depreciation and amortisation expenses for the year and profit for the year have been correctly stated.

(Emphasis supplied by the querist.)

9. At a conceptual level, this issue is common to other OMCs, who also have similar lines of business and similar accounting practice followed as that of the Company. Statutory auditors are satisfied with the accounting treatment followed by the Company.

B. Query

10. In view of the above, the opinion of the Expert Advisory Committee is sought on the following issues:

- (i) Is there any specific provision, either under Companies Act, 2013 or under Ind AS warranting fixation of residual value (in cases where assets have been carried in books by following deemed cost under Ind AS 101) by the entity, by linking it as a percentage of deemed cost?
- (ii) If reply to query (i) above is affirmative, whether such prescription is the one and only manner of measurement of residual value? Or else, whether the entity is free to estimate by linking residual value of asset either to original cost or to deemed cost or in any other manner, as long as systematic allocation of cost of assets over useful life of the assets is ensured.
- (iii) If reply to 1st part of query (ii) above is affirmative, isn't it true that the guiding principle under Companies Act, 2013, namely, residual value, should generally be not more than 5% of the original cost of the asset would be contrary to the said prescription?
- (iv) In the event, opinion of EAC would be to measure residual value as a percentage of 'deemed cost' only, would this opinion cover entire assets of the entity irrespective of whatever be the 'percentage of residual value' or else, would this requirement be applicable only when residual value as a percentage of original cost exceeds 5%?
- (v) Any other connected issues that EAC wishes to add to the query and answer the same for better clarification.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised in the query relates to whether for the purposes of requirements of Schedule II to the Companies Act, 2013, historical cost or deemed cost should be considered for change in residual value of the 'cylinders and pressure regulators' which were capitalised before Ind AS period and when the Company has elected to measure its Property, Plant and Equipment at deemed cost as per Ind AS 101. 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, other accounting aspects, such as depreciation, etc. for cylinders and pressure regulators, accounting treatment in respect of any other item of property, plant and equipment or intangible asset, whether estimates of residual value, earlier (initial) and now (revised), have been determined appropriately, compliance with the requirements of Ind AS 101 and other Standards on transition to Ind ASs, accounting for change in estimates of residual value as per the requirements of Ind AS 8, 16 and 38, etc. The Opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of various legal enactments including, in particular, the Companies Act, 2013. Further, the accounting standards referred hereinafter are Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended/revised from time to time.

12. In the context of the issue raised, the Committee notes the following definitions and requirements of Ind AS 16 and Ind AS 38 and the Schedule II to the Companies Act, 2013, as follows:

Ind AS 16

“Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Indian Accounting Standards, eg Ind AS 102, *Share-based Payment*.”

“The *residual value* of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.”

“51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.”

“53 The depreciable amount of an asset is determined after deducting its residual value. In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

54 The residual value of an asset may increase to an amount equal to or greater than the asset’s carrying amount. If it does, the asset’s depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset’s carrying amount.”

“76 In accordance with Ind AS 8 an entity discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For property, plant and equipment, such disclosure may arise from changes in estimates with respect to:

- (a) residual values;
- (b) ...”

Ind AS 38

“The *residual value* of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.”

“102 An estimate of an asset’s residual value is based on the amount recoverable from disposal using prices prevailing at the date of the estimate for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used. The residual value is reviewed at least at each financial year-end. A change in the asset’s residual value is accounted for as a

change in an accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

103 The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortisation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount."

"121 Ind AS 8 requires an entity to disclose the nature and amount of a change in an accounting estimate that has a material effect in the current period or is expected to have a material effect in subsequent periods. Such disclosure may arise from changes in:

- (a) the assessment of an intangible asset's useful life;
- (b) the amortisation method; or
- (c) residual values."

Part A of Schedule II to the Companies Act:

"1. Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value. ..."

"3. Without prejudice to the foregoing provisions of paragraph 1,—

(i) The useful life of an asset shall not ordinarily be different from the useful life specified in Part C and the residual value of an asset shall not be more than five percent of the original cost of the asset:

Provided that where a company adopts a useful life different from what is specified in Part C or uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice."

The Committee also notes the following requirements of the Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013, issued by the ICAI as follows:

"Residual Value of an Asset

15. As mentioned above, paragraph 3(i) of Part A of Schedule II, inter alia, states that the residual value of an asset shall not be more than five percent of the original cost of the asset; provided that where a company uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice. The aforesaid proviso can be taken to mean that the residual value of the asset is indicative in nature. Thus, where the estimate of the residual value of the asset is more than five percent of the original cost of the asset, the company should use that estimate of residual value provided it is supported by technical advice, external or internal, and disclosures in this regard are made as recommended later in this Guidance Note. In case the residual value is estimated to be less than five percent of the

original cost of the asset, the same should be used and it would not be necessary to make a disclosure in such a case.

...”

From the above, the Committee notes that residual value is determined for the purpose of determining the depreciable amount of an asset so as to allocate that depreciable amount over the useful life of the asset in a systematic manner. Determination of residual value of PPE or intangible asset is an independent technical process of estimation based on the amount recoverable from disposal using prices prevailing at the date of the estimate for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used. The Committee is of the view that the residual value is estimated technically at the beginning of the useful life of the asset and is assessed/reviewed periodically to determine whether there is any change in the original estimate or not. Thus, such process of estimation of residual value is an independent exercise and should not be benchmarked with the cost of the asset (either historical or deemed). In practice, the residual value of an asset is often insignificant and immaterial. Further, as per the requirements of Schedule II to the Companies Act, 2013, it shall not be more than 5% of the original cost of asset unless it is properly justified, duly supported by technical advice and adequately disclosed in the financial statements. Thus, for the purpose of compliance with the requirements of Schedule II to the Companies Act, 2013, the Company has to link it with the original cost (which is also sometimes termed as ‘historical cost’) so as to ensure that the residual value is not normally more than 5% of the original cost and in case, it is so, to provide adequate and appropriate disclosures considering the requirements of Schedule II.

13. The Committee notes that the Schedule II uses the term ‘original cost’, which is normally construed as the actual cost incurred by the Company on an asset and which as per Ind AS 16 is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Indian Accounting Standards. Accordingly, the Committee is of the view that as per the requirements of the Schedule II, the residual value or any changes in such residual value are linked or compared with/to original cost and not with the deemed cost.

D. Opinion

14. On the basis of above, the Committee is of the following opinion on the issues raised in paragraph 10 above:

- (i) The process of estimation of residual value is an independent exercise and should not be benchmarked with the cost of the asset (historical/original or deemed). Further, as per the requirements of the Schedule II to the Companies Act, 2013, the residual value or any changes in such residual value are linked/compared with/to original cost and not with the deemed cost.

(ii) to (iv) In view of (i) above, answer to these questions does not arise.

- (v) The question raised by the querist is not any specific issue; rather is a generic question. Therefore, this cannot be answered as the Committee answers only specific issues.
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