

## **Query No. 7**

**Subject: Accounting treatment of Aviation Turbine Fuel (ATF) dead stock.**<sup>1</sup>

### **A. Facts of the Case**

1. A Company (hereinafter referred to as ‘the Company’) had been incorporated by ABC Private Ltd. as a private Company limited by shares under the Companies Act, 1956, as its wholly owned subsidiary. Thereafter, on 6<sup>th</sup> March 2014, three other oil public sector undertakings (collectively referred to as the ‘Oil PSUs’) and ABC Pvt. Ltd. entered into the Shareholders Agreement; and Oil PSUs, ABC Pvt. Ltd. and its wholly owned subsidiary entered into Share Purchase Agreement. ABC Pvt. Ltd. and the Oil PSUs have formed a joint venture Company, viz., the Company in the extant case. The objectives of the Company are given below:

- To take over existing aviation fuelling facilities and businesses including without limitation aviation fuelling stations, tankage, hydrant infrastructure.
- To create, establish, design, construct, develop, upgrade, modernise, integrate, optimize and modify fuelling facilities for the Airport.
- To operate, manage and maintain and to provide services in relation to the fuelling facilities for the Airport, on an open access basis.

2. The Company is in the process of creating a modern and efficient aviation fuel facility to cater to the needs of airlines operating from Chhatrapati Shivaji International Airport (CSIA). The Company has also undertaken the development of the Integrated Facility and linking thereof to the Hydrant System. The Company has executed License Agreement with Airport Operator (ABC Pvt. Ltd.) for two locations, Location 1 and location 2. The fuel farm operations are being carried out at Location 1 and the project of development of integrated fuel farm facility is carried out at Location 2.

3. The querist has also provided the following facts:

- (a) Dead stock is the minimum level of material needed to be maintained in the plant and machinery for the plant and machinery to operate for its intended use.
- (b) The aviation turbine fuel (ATF) dead stock in the present case is the minimum level of material required in the storage tanks to operate for its intended use. Minimum level of fuel is required to be maintained in the storage tanks by design/nature as, below this level, the fuel cannot be withdrawn from the tanks. It is not at the discretion of the Company.
- (c) The dead stock held by the Company is not held for sale in its ordinary course of business since the Company’s business is to provide storage space for storing fuels and not to buy or sell fuel.
- (d) This dead stock quantity will never undergo any changes and shall remain intact till the life of the facility.

4. The querist has referred to the following paragraphs of various Indian Accounting Standards (Ind ASs):

*Ind AS 2, ‘Inventories’:*

**“Inventories are assets:**

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<sup>1</sup> Opinion finalised by the Committee on 23.5.2020.

- (a) held for sale in the ordinary course of business;
- (b) in the process of production for such sale; or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.”

“8 Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process. Costs incurred to fulfill a contract with a customer that do not give rise to inventories (or assets within the scope of another Standard) are accounted for in accordance with Ind AS 115, *Revenue from Contracts with Customers*.”

*Ind AS 16, 'Property, Plant and Equipment':*

- “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.”

5. The dead stock held by the Company is not held for sale in its ordinary course of business since the Company’s business is to provide storage space for storing fuels and not to buy or sell fuel. Accordingly, conditions (a) and (b) of paragraph 6 of Ind AS 2 are not applicable to the Company. Moreover, the dead stock is not consumed in the services related to storage of fuel, since this is the minimum level of material which is required to be held at all times in the oil storage tank in order to make it operational throughout its life. Hence, the stock is not consumed during the production process. As a result, condition (c) of paragraph 6 of Ind AS 2 is also not applicable to the Company.

6. Based on the facts of the case, according to the querist, it is evident that the dead stock is held with the intention of enabling the machinery to perform its intended functions and render storage services. Accordingly, the cost of acquiring dead stock is in the nature of a cost that is directly attributable cost of bringing the oil storage tanks/plant and machinery to its working condition for its intended use of providing storage services.

7. The querist has stated that the basic principle to be applied while capitalising an item of cost to a fixed asset/project under construction is that it should be directly attributable to the fixed asset for bringing it to its working condition for its intended use. The costs that are directly attributable to the acquisition of a fixed asset for bringing it to its working condition are those costs that would have been avoided if the acquisition had not been made. These are the expenditures without the incurrance of which, the asset could not be brought to its working condition, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. The above-discussed principle of avoidance of costs as the basis of identifying directly attributable cost for the purpose of capitalisation is also supported by Ind AS 16. In the given case, the dead stock is necessary to bring the property, plant and equipment in a condition necessary for it to be operating in a manner as intended by the Company.

8. As per paragraph 6 of Ind AS 16, “**Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.**” As per the querist, depreciation is a

measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is pre-determined. Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

9. As per paragraph 6 of Ind AS 16,

***Useful life is:***

- (a) the period over which an asset is expected to be available for use by an entity; or**
- (b) the number of production or similar units expected to be obtained from the asset by an entity.**

Accordingly, even if the assets have a longer physical useful life, if the management estimates that they will actually be used for a period shorter than the physical life, the period over which the asset is expected to be used by the management would be considered for the purposes of determining the depreciation charge.

10. The querist has further referred to the requirements of Schedule II to the Companies Act, 2013 (the Act) with respect to depreciation as below:

“The useful life of an asset shall not be longer than 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 uses a useful life or residual value of the asset which is different from the above limits, justification for the difference shall be disclosed in its financial statements.”

Thus, according to the querist, the Company may on the basis of an objective technical and economic evaluation, determine a residual value of more than 5% and a useful life of plant and machinery different from that prescribed in the Act. However, it would be required to disclose the facts and disclose reasons for the same.

11. The querist has stated that the useful life for plant and machinery (storage tanks and related equipment) used in exploration, production, and refining oil and gas, as prescribed in the Act is 25 years. However, it may be noted that Schedule II recognises the concept of component accounting. Note 4 in Schedule II, *inter alia*, states as below:

- “a) 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.”

Two issues arise in this context. Firstly, is the value of dead stock significant to the total cost of the storage tank. If so, the Company should treat it as a separate component. Its useful life should be evaluated and it should be considered whether it would need recharging or whether there is an expected loss in the quantity or value of dead stock over the life of the asset of which it is a part. If so, depreciation should be charged on this component separately. This would also depend upon the fact whether loss relating to dead stock (if any) is borne by the Company or whether as per fuel sale agreements, it is

compensated by the customers. In this context, reference to clause 18.03.1 of License Agreement between the Company and ABC Pvt. Ltd. may be made, which spells that for transfer back of property including dead stock, the transfer payment will be as mutually discussed and agreed.

12. The querist has informed that as per an independent accounting opinion obtained by the Company, depreciation should be charged on the dead stock over its expected useful life.

13. Accounting treatment by the Company and disclosure in its books of account:

- (a) The Company is accounting for ATF dead stock held by it in storage tanks as part of 'Fixed Assets' under the head 'Plant & Machinery'.
- (b) The dead stock has been accounted for in the books at the actual cost of acquisition. However, out of the total dead stock, 553.73 KL of ATF was transferred by ABC Pvt. Ltd. to the Company at Rs. 10.20 crore, which was duly certified by their statutory auditors. The purchase cost works to approx. Rs. 1,84,205/- per KL as against the current market price of Rs. 64,321/- per KL.
- (c) The dead stock is not subject to depreciation and disclosure is being made in the books accordingly.

14. As per an independent accounting opinion obtained by the Company and advice from the statutory auditor, adequate disclosure is given in the books of account of the Company related to treatment of dead stock. The same is reproduced below:

- i. Paragraph 2.5 (vi) of Notes to Financial Statements, "Dead stock is the minimum level of material needed to be maintained in the plant and machinery for its intended use. Minimum level of fuel is required to be maintained in the storage tanks by design / nature, below this level the fuel cannot be withdrawn from the tanks. The dead stock held by the Company is not held for sale in its ordinary course of business. Accordingly, as per paragraph 16 of Ind AS 16, the cost of acquiring dead stock is in the nature of a cost that is directly attributable cost of bringing the oil storage tanks / plant and machinery to its working condition for its intended use of providing storage services and accordingly form part of Fixed Assets."
- ii. Para 2.6 (iv) of Notes to Financial Statements, "Depreciation on dead stock forming part of Fixed Assets is provided on the basis of diminution in the value of the dead stock calculated on realization price method, if such diminution in value is not temporary."

## **B. Query**

15. On the basis of above, the querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the following issues:

- (i) Whether accounting for dead stock as part of property, plant and equipment is appropriate or it should be classified as inventory.
- (ii) Whether the dead stock value needs to be impaired based on current net realizable value or to be continued at acquisition cost.
- (iii) No depreciation is being claimed by the company, considering the diminution in value is temporary in nature and not permanent. Whether depreciation is to be claimed on dead stock valuation and if so, whether prospectively or

retrospectively and methodology of depreciation.

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

16. The Committee notes that the basic issue raised in the query relates to accounting for the dead stock acquired/purchased by the Company from ABC Pvt. Ltd. and oil PSUs. 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, whether the joint arrangement between the ABC Pvt. Ltd. and oil PSUs is a joint venture or not, accounting for the arrangement between the Company and ABC Pvt. Ltd. and oil PSUs, accounting for storage tanks held by the Company as licensee, accounting treatment of other assets which are part of the license agreement or transfer deed between the Company and ABC Pvt. Ltd./oil PSUs, the appropriateness of the cost/value at which ATF is acquired by the Company from ABC Pvt. Ltd. etc. Further, the opinion is expressed purely from the accounting perspective and not from any other perspective, such as, interpretation of license agreement or transfer deed, as referred/supplied by the querist. Further, in the context of the query raised, the Committee presumes that the dead stock has been acquired/purchased by the Company from ABC Pvt. Ltd. and oil PSUs and is not held in fiduciary capacity or on their behalf.

17. At the outset, the Committee notes from the license agreement that at the expiry/end of the license term, the company will transfer back the ownership of and all rights, title and interest including ATF at a mutually discussed and agreed value to ABC Pvt. Ltd. Thus, the price for the transfer-back or repurchase by the licensor has not been fixed or pre-determined. Further, this indicates that the company shall keep the ATF dead stock till the expiry of the license term and will return the dead stock in the condition at that point of time, at the then prevailing prices. Therefore, the risks and rewards of inventory price changes during the license period vest with the company. Moreover, since the company has acquired legal title of the ATF stock and apparently, during the term of the license agreement, the company shall keep this minimum stock of ATF for providing storage services to its customers, it has the ability to prevent other entities from directing the use of and obtaining the benefits from it. This indicates that the company has the ability to direct the use of the dead stock of ATF for its storage service rendering activities, and obtain substantially all of the remaining benefits therefrom during the license term. Therefore, the company in the extant case acquires 'control' over the ATF stock and the same is an 'asset' of the company.

18. Further, in order to determine the classification of the asset, the Committee notes the definition of the term 'inventories' as given in Indian Accounting Standard (Ind AS) 2, 'Inventories', and the definition of the term 'property, plant and equipment' as given in Ind AS 16, 'Property, Plant and Equipment', as follows:

***“Inventories are assets:***

- (a) held for sale in the ordinary course of business;**
- (b) in the process of production for such sale; or**
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.”**

***“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.”**

“16 The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.”

From the above, the Committee notes that the classification of an asset as a ‘property, plant and equipment’ or ‘inventory’ depends on its intended primary use for an entity. If an asset is essentially held for use in the production or providing goods or services or for rental or administrative purposes, it is classified as ‘property, plant and equipment’. However, if it is held for sale in the ordinary course of business, or if it is used in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services, the asset should be classified as inventory.

19. The Committee notes from the Facts of the Case that the minimum level of oil is not held by the company for sale in its ordinary course of business since the company is in the business of providing storage services rather than buying or selling fuel. The Committee also notes that the key characteristic of ATF dead stock is that a minimum constant level of such stock is required to be maintained in the storage facility/tanks. As such, the minimum level of inventories of the same quantity, characteristics and use is always present in the storage facility, whether these are comingled with other inventories or not. Consequently, the Committee is of the view that this part of the inventories should be looked at collectively, ie as if it were a single item, notwithstanding the fact that this ATF stock is comingled with fresh stock continuously. The Committee notes that this minimum level can neither be extracted and sold in ordinary course of business nor it is consumed in the process of rendering of the services (storage services in the extant case). Therefore, the same does not meet the definition of ‘Inventory’. Moreover, although the composition of dead stock may change over a period of time, a minimum quantity of ATF is always required to be maintained in oil tanks for them to be capable of operation, viz., in providing the storage services. Thus, the Committee notes that this minimum level of stock is necessary to ensure that the facility is functional; it is inseparable from the facility for its operation and is always required to be maintained in the storage tanks/facility by design/nature to make them operative. Thus, it is in the nature of cost which is directly attributable to bringing the asset (storage tanks) to the location and condition necessary for it to be capable of operating in the manner intended by management and therefore, it is an element of cost of another PPE (viz., the storage tanks) and should be recognized as part of cost of storage tanks.

20. With regard to the measurement of ATF dead stock, the Committee notes the following requirements of Ind AS 16:

**“15 An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.**

**“Measurement after recognition**

- 29 An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.**

**Cost model**

- 30 After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.**

**Revaluation model**

- 31 After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.”**

From the above, the Committee notes that the storage tank should be initially measured at its cost, which will be its purchase price and any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. After recognition, the entity can use cost model or revaluation model as per the policy followed for entire class of Property, Plant and Equipment. Further, impairment should also be tested and provided for as per the requirements of Ind AS 36, ‘Impairment of Assets’.

21. As far as depreciation is concerned, the Committee notes the following requirements of Ind AS 16 and Schedule II to the Companies Act, 2013 as follows:

*Ind AS 16:*

**“Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.”**

**“Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.”**

**“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.”**

**“Useful life is:**

- (a) the period over which an asset is expected to be available for use by an entity; or**
- (b) the number of production or similar units expected to be obtained from the asset by an entity.”**

**“43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.”**

- “50 The depreciable amount of an asset shall be allocated on a systematic basis over 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*.**
- 52 Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset’s residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.
- 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.”
- “57 The useful life of an asset is defined in terms of the asset’s expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.”

*Schedule II to the Companies Act, 2013:*

“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.”

Further, Note 4 in Schedule II, *inter alia*, states as below:

- “(a) 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.”

From the above, the Committee notes that depreciation is a systematic allocation of depreciable amount of an asset over its expected useful life. Further, where the 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. Furthermore, where a company uses a useful life or residual value of the asset which is different from the limits prescribed in Schedule II to the Companies Act, 2013, justification for the difference shall be disclosed in its financial

statements. Thus, in the extant case, the company should first assess whether cost of ATF dead stock is significant to total cost of the storage tanks and whether useful life of that part is different from the useful life of the remaining asset and if yes, depreciation on ATF dead stock should be provided for separately from the storage tanks of which it is a component. For this purpose, the useful life and the residual value shall be determined and reviewed as per the above-reproduced requirements of Ind AS 16. Thus, the depreciable amount of ATF dead stock should be depreciated over its useful life in accordance with the requirements of Ind AS 16. However, if the residual value of ATF dead stock increases to an amount equal to or greater than its carrying amount, the depreciation charge should be zero unless and until its residual value subsequently decreases to an amount below the carrying amount, as per paragraph 54 of Ind AS 16.

However, if cost of ATF dead stock is not significant to total cost of the storage tanks and/or useful life of ATF dead stock is not different from the useful life of the remaining asset, no separate depreciation needs to be determined for this stock and the depreciation on ATF dead stock will be provided as a part of depreciation on storage tanks, as per the requirements of Ind AS 16 and Schedule II to the Companies Act, 2013.

#### **D. Opinion**

22. On the basis of above, the Committee is of the following opinion on the issues raised in paragraph 15 above:

- (i) The accounting for ATF dead stock by the company as part of ‘property, plant and equipment’ is appropriate, for the reasons mentioned in paragraphs 18 and 19 above. However, the same should be adequately and appropriately presented and disclosed from the perspective of users of financial statements as per the requirements of paragraph 122 of Ind AS 1.
- (ii) The ATF dead stock, being a part of Property, Plant and Equipment, should be measured as per the requirements of Ind AS 16, as discussed in paragraph 20 above. Further, impairment should also be tested and provided for as per the requirements of Ind AS 36, ‘Impairment of Assets’.
- (iii) Refer paragraph 21 above.

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