

Query No. 11

Subject: Accounting treatment of construction of facilities for import of additional requirement of power.¹

A. Facts of the Case

1. A Company (hereinafter referred to as ‘the Company’), is a Government of India Undertaking, which is engaged in refining of crude oil and having a refining capacity of 3.0 MMTPA (Million Metric Tonne per Annum). The Company is jointly owned by A Ltd., B Ltd. and Government of Assam (GoA). A Ltd. holds 61.65% shares whereas B Ltd. and GoA own 26% and 12.35% respectively. The refinery is located in Golaghat district of Assam and is the fourth refinery in the state of Assam. The capacity of the refinery is being enhanced from 3.0 MMTPA to 9.0 MMTPA.

2. The Company is presently running the refinery from power generated from its own captive power plants. The power is generated from Gas Turbine Generator (GTG) and Steam Turbine Generator (STG) with natural gas. The present power requirement is 35 MW. However, with refinery expansion, requirement of power will be increased by around 80 MW from the present requirement. The said power requirement can be met either through grid power (220 KV grid connectivity) or through captive power.

3. The key drivers of the project to have 220 KV grid connectivity are as follows:

a) Revenue maximisation

Grid power is available at a cheaper rate in comparison to cost of captive power.

b) Compliance to Ministry of Petroleum and Natural Gas (MoP&NG) Guidelines

MoP&NG is emphasising on use of Grid power instead of captive power with the intent of avoiding burning of fossil fuel in the power plants and thereby minimising fuel and loss. This also bears a direct impact on environment in general and nation at large.

c) Value addition to company’s upcoming projects

The company’s upcoming Bio Refinery Project will produce surplus electricity which will have to be either consumed in the refinery or exported to Grid based on value proposition.

d) Refinery expansion

The proposed expansion of refinery to 9.0 MMTPA, additional power demand is projected to be 74 MW. With the open access connectivity to Grid, the Company will be able to purchase stable power instead of setting up captive plants which is more capital cost intensive than developing the transmission infrastructure.

e) Power Reliability and Risk Mitigation

The national grid power is very stable and connectivity to national grid will enhance power security for the Company. Power failure in the Company has been identified as

¹ Opinion finalised by the Committee on 22.7.2021.

one of the major risks which requires mitigation strategy. The Grid connectivity will ensure un-interrupted power supply for reliable refinery operation.

In view of the above, the Company and State Electricity Grid Corporation (hereinafter referred to as 'C Ltd.') have entered into a memorandum of understanding (MoU) (a copy of which has been supplied separately by the querist for the perusal of the Committee), whereby the Company is required to set up infrastructure for import of Grid power to enhance reliability and availability of power to sustain operations of its refinery located at Numaligarh, Assam. The power is to be procured from electricity grid operated by C Ltd. C Ltd. has agreed to take up construction of infrastructure up to the boundary of the Company for facilitating it to procure power from C Ltd.'s Grid. The cost for the construction of infrastructure up to the boundary of the Company would be Rs. 185.32 crore which would be borne by the Company. This cost will benefit the Company in terms of continuous availability of cheap power to run its new 6 MMTPA new Refinery. Further, there will be two distinct future benefits to the Company due to grid connectivity.

- i. Over time, with increased renewable capacity, the grid power will incrementally become green and the Company will get benefit in terms of augmenting its carbon footprint reduction.
 - ii. With this connectivity, the Company, in future, will be able to leverage on the group captive option of power generation and consumption beyond its refinery premises. Creation of the infrastructure will ensure adequate power supply to the Company for its new 6 MMTPA Refinery. Without this infrastructure, the Company will not be able to have the power to run the new 6 MMTPA Refinery. Power for the new 6 MMTPA new Refinery would then need to be met by setting up its own captive power plant which will mean incurring huge capex by the Company.
4. The querist has stated that the entire construction and commissioning activities are divided into three parts with detailed cost break-up as under:

(A) 220 KV Over Head (OH) Line :

Supply, installation, testing and commissioning of 220 KV double circuit, OH line to the Company from C Ltd. Grid point (approximate distance of 11 Km) including acquisition of required land for construction. The work will be carried out as deposit work basis whereby the Company will reimburse the cost against utilisation. The Company shall reimburse cost of land to C Ltd. and ownership of the land shall vest with C Ltd. The OH line will be owned, operated and maintained by C Ltd. after commissioning. Operation and maintenance charge will be payable by the Company to C Ltd. as per CERC/AERC regulation. The major break-up of cost for this 220 KV OH line is as under:

Head of Expenditure	Amount (Rs./crs)
ROU Compensation	3.08
Supply Erection	13.95
Total	17.03

(B) 220 KV Gas insulated Substation (GIS):

Supply, construction installation, testing and commissioning of 220 KV GIS in all respect in the location near refinery complex. The work will be carried out as deposit work basis whereby the Company will reimburse the cost against utilisation. The 220

KV GIS line will be owned, operated and maintained by C Ltd. after commissioning. Operation and maintenance charge will be payable by the company to C Ltd. as per CERC/AERC regulation. The major break-up of cost for this 220 KV GIA is as under:

Head of Expenditure	Amount (Rs./crs)
Land acquisition	10.28
Supply and Erection	146.01
Total	156.29

(C) 220/33 KV Switch Yard:

Supply, installation, testing and commissioning of 220/33 KV Switch yard inside refinery complex at the Company. The Switch yard will be owned, operated and maintained by the Company after commissioning. The job will be carried out by the Company and C Ltd. will provide Detail Design Consultancy, Tender Preparation and Tender Evaluation for the job. The cost of installation (both supply and erection) is around Rs. 12 crore.

5. The summarised cost break-up for this project is as under:

Particulars	Cost to be borne by the company (Rs. in Crs)
(A) 220 KV Over Head (OH) Line up to the Company's boundary – Line to be owned, operated by C Ltd.	17.03
(B) 220 KV Gas insulated Substation (GIS) - to be located near refinery complex and to be owned, operated by C Ltd.	156.29
(C) 220/33 KV Switchyard inside refinery complex of the Company and to be owned, operated by the Company	12.00
Total	185.32

6. The querist has also pointed out that although infrastructure is created to meet enhanced power requirement of the Company, C Ltd. also has the option to sell power to household/other industry in and around refinery area from this Grid. After meeting the Company's requirement from the transmission infrastructure in totality, C Ltd. can cater to the requirements of some small local consumers. The querist has also separately informed that at present, there is no agreement between the Company and C Ltd. for assured/minimum quantity of power. Further, at a later date, closer to completion of the project, a separate power purchase agreement will be entered into with the power supplier as grid power will be taken through open access mechanism. However, C Ltd. is responsible to make the quantity of power available to the Company as per the Agreement/MOU signed between the parties, through this infrastructure.

B. Query

7. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- i. Whether above expenditure (A, B and C) would be capital or revenue expenditure for the Company. In case the same is a capital expenditure whether expenditure incurred

to be recognised as an individual item of Property, Plant and Equipment or the same to be capitalised as a part of overall cost of the project.

- ii. In case capital, what shall be the useful life of the asset? It may be noted that life of the present refinery is expected to be over by 2025. However, present refining capacity of the Company shall be enhanced from existing 3 MMTPA to 9 MMTPA and project is expected to be completed by 2024. Accordingly, life of the enhanced 6 MMTPA will be taken as 25 years up to 2049.
- iii. In case the expenditure is of revenue nature, manner in which same shall be charged off, i.e., whether in one year and can spread over more than one year.
- iv. What will be the accounting treatment to be done by the company for the payment kept as Deposit with C Ltd. during the construction period and the accounting treatment to be done on completion of the Project?
- v. In case the expenditure to be treated as capital, how the same is to be presented in the financial statements of the Company?

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to accounting treatment of expenditure incurred for construction of facilities to import power to the Refinery of the Company (hereinafter referred to as 'the transmission infrastructure'), which will be used for the power requirement of the present as well as proposed expansion Project, in the financial statements of the Company. The Committee has, therefore, considered only this issue and has not examined any other issue(s) that may arise from the Facts of the Case, such as, accounting for expenditure incurred for the proposed expansion of refinery etc., accounting for operation and maintenance expense/charge to be paid by the Company to C Ltd., accounting for any financing element in the above-mentioned transactions, impairment of the assets recognised (if any), etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from legal perspective, such as, legal interpretation of the Guidelines of Ministry of Petroleum and Natural Gas, Memorandum of Understanding between the Company and C Ltd. etc. Further, the Committee wishes to point out that the Indian Accounting Standards referred to in the Opinion are the Standards notified by the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

9. At the outset, the Committee notes from the Facts of the Case that the Company is required to set up infrastructure for import of Grid power from C Ltd.'s Grid to the Company's boundary. Such infrastructure enhances reliability and availability of power to sustain operations of its existing refinery located at Numaligarh as well as proposed expansion of the refinery. With the open access connectivity to Grid, the Company will be able to purchase stable power instead of setting up captive plants which is more capital cost intensive than developing the transmission infrastructure. Thus, the infrastructure results in future economic benefits for the Company. For the said infrastructure, the Company is required to make payments to C Ltd. for three parts as follows:

- (A) 220 KV Over Head (OH) Line, which will be owned, operated and maintained by C Ltd.
- (B) 220 KV Gas insulated Substation (GIS), which will be owned, operated and maintained by C Ltd.
- (C) 220/33 KV Switchyard inside refinery complex of the Company, which is to be owned, operated and maintained by the Company.

10. With regard to the accounting for the expenditure on construction of transmission infrastructure in the extant case, the Committee notes that the first issue to be examined is whether an individual asset (tangible or intangible) may be recognised in respect of such expenditure. In this regard, the Committee notes the definition of ‘asset’ from Ind AS 38, ‘Intangible Assets’ and paragraph 13 thereof with regard to ‘control’ as follows:

“An asset is a resource:

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.”

“Control

13 An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.”

The Committee further 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.”

“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.”

“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 although the infrastructure constructed by C Ltd. in the extant case will result into future economic benefits, as mentioned in paragraph 9 above and the cost can also be measured reliably, the same, *other than switchyard in the Refinery complex of the Company*, will not result into any individual tangible asset controlled by the Company, as neither the Company owns the infrastructure nor it can restrict others from having access of benefits from the infrastructure. Therefore, infrastructure *other than Switchyard* cannot be recognised as an individual item of PPE as per the principles of Ind AS 16. However, the Switchyard, since results into a tangible asset controlled by the Company, may be recognised as an individual item of PPE if it meets the recognition conditions as per above-reproduced paragraph 7 of Ind AS 16.

11. The Committee also examines whether the above expenditure (other than switchyard) results into an intangible or right-of-use of asset for the Company. In this regard, the Committee notes the following requirements of Ind AS 38 and Ind AS 116:

Ind AS 38

“An *intangible asset* is an identifiable non-monetary asset without physical substance.”

“Intangible assets

- 9 Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.
- 10 Not all the items described in paragraph 9 meet the definition of an intangible asset, ie identifiability, control over a resource and existence of future economic benefits. If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date (see paragraph 68).”

“Identifiability

...

- 12 An asset is identifiable if it either:
- (a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or
 - (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Control

- 13 An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.”

Ind AS 116

“Lease A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.”

“9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.

10 A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).”

“B9 To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the *period of use*, the customer has both of the following:

- (a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21– B23); and
- (b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

B10 If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.”

“B20 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Right to obtain economic benefits from use

B21 To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.”

“Right to direct the use

B24 A customer has the right to direct the use of an identified asset throughout the period of use only if either:

- (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25–B30); or
- (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
 - (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
 - (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.”

The Committee notes that paragraph B24 of Ind AS 116 specifically provides that where the relevant decisions about how and for what purpose the asset is used are predetermined (as in the case of transmission infrastructure in the extant case), an entity shall have the right to direct the use of an identified asset throughout the period of use only if it has the right to operate the asset or if it designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use. Since in the extant case, the Company neither has the right to operate the asset nor it appears to have designed the asset in the manner as discussed above (as, according to one of the clauses of MoU between the

Company and C Ltd., detailed design consultancy for the infrastructure is being provided by the C Ltd.), the Company cannot be considered to have the right to direct the use of the transmission infrastructure. Accordingly, the Committee is of the view that the arrangement between C Ltd. and the Company, in respect of transmission infrastructure, does not contain a lease and is not within the scope of Ind AS 116.

The Committee further notes from the above-reproduced requirements of Ind AS 38 that in order to meet the definition of an intangible asset, three conditions should be fulfilled, viz., identifiability, control over a resource and existence of future economic benefits. With regard to these conditions, the Committee notes from the Facts of the Case that C Ltd. has the option to sell power to household/other industry in an around refinery area from the Power Grid. Further, after meeting the Company's requirement from the transmission infrastructure, C Ltd. can cater to the requirements of some small local consumers. Furthermore, although the querist has informed that C Ltd. is responsible to make the quantity of power available to the Company through the infrastructure as per the Agreement/MOU, at a later date, closer to completion of the project, a separate power purchase agreement will be entered into with the power supplier (which is not C Ltd.) and grid power will be taken through open access mechanism. Thus, C Ltd. is only a power transmission entity which facilitates transmission of power and does not provide power as such. By incurring expenditure on transmission infrastructure as aforementioned, the Company is only getting a right to use the infrastructure but that right is not exclusive; the infrastructure can be used to cater to the requirements of other customers as well. Thus, although the Company has the power to obtain the future economic benefits flowing from the underlying asset (viz., right to use the infrastructure), it cannot restrict the access of other to those benefits. Therefore, the Company cannot be considered to have 'control' over the asset. Accordingly, the same cannot be accounted for as an intangible asset in the financial statements of the Company.

12. Now, the Committee examines whether the cost incurred on transmission infrastructure by the Company (which is not already capitalised as an individual item of PPE as per the above discussion) can be included as a part of cost of expansion Project of the Refinery. In this regard, the Committee notes that paragraph 16 of Ind AS 16, inter alia, states that the cost of an item of property, plant and equipment comprises 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. The costs that are directly attributable to the construction/acquisition of an item of PPE/project for bringing it to its working condition are generally those directly related costs that would have been avoided if the construction/acquisition had not been made. These are the expenditures without the incurrance of which, the construction of project/asset could not have taken place and the project/asset could not be brought to the location and condition necessary for it to be capable of operating in the manner intended by management, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. In this context, the Committee notes that in the absence of the power, which is accessed through the infrastructure created, the expanded Refinery cannot be operated and therefore, the above-said expenditure can be considered as directly attributable to bringing the Refinery project to the location and condition necessary for it to be *capable of operating* in the manner intended by management. Accordingly, such expenditure should be included as a part of cost of expansion Project of the Refinery. However, the capitalised asset should be tested for impairment as per the requirements of Ind AS 36, 'Impairment of Assets'.

13. As far as useful life of the capitalised property, plant and equipment is concerned, the Committee notes the requirements of Ind AS 16, which are reproduced below:

“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.

44 An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft. Similarly, if an entity acquires property, plant and equipment subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms.

45 A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

46 To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.”

“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.”

From the above, the Committee notes that the useful life of PPE should be determined as per the above-reproduced requirements of Ind AS 16. Further, as per the above requirements of Ind AS 16, the amount initially recognised in respect of an item of property, plant and equipment is allocated to its significant parts and each such part is depreciated separately if they have a useful life which is different from the useful life of the item of property, plant and equipment to which they relate. Accordingly, in the extant case, the amount initially recognised as cost of Refinery should be allocated to its various significant parts having a different useful life and should be depreciated separately as per the above-reproduced requirements of Ind AS 16.

14. As far as the accounting treatment of the payment kept as Deposit with C Ltd. during the construction period, the Committee notes from the MoU signed between the Company and C Ltd. that as per the detail estimate accompanied by demand notice to be given by C Ltd., the

Company will deposit the amount to C Ltd. to execute the jobs. For project works mentioned at paragraph 9A above, C Ltd. has already submitted an estimate of Rs. XXX and the Company agreed to deposit the amount in one installment to C Ltd. to kick start the project post signing of MoU. Similarly, payment for project works mentioned at paragraph 9B above, will be milestone based and the Company will deposit the amount against each milestone, which is to be decided in mutual agreement by both the parties. From this, the Committee is of the view that the deposit made by the Company to C Ltd. are in the nature of advances for the execution of work and therefore, same should be treated/ shown as capital advance till the time the work is performed in respect of such advance, which thereafter should be recognised as capital work-in-progress or the PPE, as the case may be.

15. Further, with regard to presentation of capitalised PPE in the financial statements of the Company, the Committee is of the view that the Company should comply with the requirements of Ind AS 16 and Division II of Schedule III to the Companies Act, 2013.

D. Opinion

16. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

- (i) Refer to paragraphs 10 to 12 above.
- (ii) Refer to paragraph 14 above.
- (iii) Answer to this Question does not arise.
- (iv) As far as the accounting treatment of the payment kept as Deposit with C Ltd. during the construction period, the Committee is of the view that the same should be treated/shown as capital advance till the time the work is performed in respect of such advance, which thereafter should be recognised as capital work-in-progress or the PPE, as the case may be.
- (v) Refer to paragraph 15 above.
