

Query No. 6

Subject: *Treatment of dredging and reclamation (site grading) cost on leased land.*¹

A. Facts of the Case

1. A public limited company (hereinafter referred to as ‘the Company’) is a Maharatna public sector undertaking under the administrative control of the Ministry of Petroleum and Natural Gas, Government of India and is engaged in the business of refining and marketing of petroleum products. Together with 2 other public sector undertakings in the Industry, it is also known as one of the Oil Marketing Companies (OMC).

2. The Company conceived a project to set up a 9 Million Metric Tonne Per Annum (MMTPA) Grass-root oil Refinery at Paradip for which land was taken on lease for the period of 90 years in year 2001 from Orissa Industrial Infrastructure Development Corporation (OIDC) established under the OIIDC Act, 1980. The land for Paradip Refinery site was taken on lease for Rs. 79 crores.

3. The querist has informed that during execution of lease contract, it was known that allotted land is in a very low-lying area and could not be used as it is for its intended purpose. Since its height had to be increased by 4 meters approximately above the mean sea level, heavy dredging and reclamation cost was required to be incurred to make it ready for intended use.

4. The querist has further informed that the dredging of the river basin was carried out as per the dredging plans prepared by National Institute of Oceanography (NIO), Goa. Since the area site is a low-lying area, reclamation by filling with sand was done. Reclamation area was elevated from +1.0m to +4.0m spread over the entire low-lying land exposed to subsoil waters during tidal variations. Therefore, heavy land filling cost was incurred to bring the land to useable condition. Land filling costs to the tune of Rs. 741 crores was incurred on that land to bring the land in usable condition.

5. The querist has also informed that during the commencement and capitalisation of project, accounting as per the then applicable Indian GAAP was followed as Indian Accounting Standards (Ind AS) were not introduced. Under the erstwhile Accounting Standard (AS) 19, ‘Leases’, land leases were specifically excluded, hence, citing the principles of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, the cost of land was capitalised alongwith the cost of land development expenditure under the category of leasehold land in the financial year (F.Y.) 2012-2013 after execution of lease deed.

6. After implementation of Indian Accounting Standards, land leases were covered under Ind AS 17, ‘Leases’. This lease was categorised as operating lease and carrying value of the land as on 01.04.2015 was transferred to prepaid rentals. Further, after implementation of Ind AS 116, ‘Leases’, the remaining amount of prepaid rentals as on 01.04.2019 was transferred under Right of Use asset for remaining lease period under the provision of the revised Ind AS, viz., Ind AS 116.

¹ Opinion finalised by the Committee on 6.5.2021.

7. The querist has mentioned that besides above, to bring more clarity to the readers of the financial statements, appropriate disclosure in Note -2, Property, Plant and Equipment has been given as “Leasehold Land (included in ROU asset) includes an amount of Rs. 716.41 crore for Land Development Cost.”

8. The querist has given below the accounting treatment followed by the Company in past periods as per the requirements of Standards:

1. At the time of execution of lease deed:

Under AS 19, ‘Leases’, lease agreements for use of land are excluded. As per AS 10, ‘Accounting for Fixed Assets’, the cost of fixed asset should comprise the purchase price and any attributable cost of bringing asset to the working condition for the intended use. Cost of land should generally include:

- Acquisition cost
- Cost incurred in obtaining title
- Cost of surveys
- Cost incurred in preparing the land for its particular use.

Based on the principles of Accounting Standards, it was concluded that the very purpose of development activity is to make the asset ready for intended use. As evident from the facts above, the development cost was incurred to prepare the land for setting up of the plant (intended/ ultimate use), the dredging and reclamation cost was capitalised under the fixed asset as land. Accordingly, leasehold land was capitalised in books along with the cost of dredging and reclamation for Rs.820 crores (including Rs.741 crores as land development cost) with useful life of lease period.

2. Transition to Indian Accounting Standards

As per Ind AS 17, a lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Finance Lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An operating lease is a lease other than a finance lease.

As per paragraph 33 of Ind AS 17, lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit.

Hence, agreement with OIIC for Paradip Refinery site land is a lease under Ind AS 17 and was accounted for as per the provisions of the Standard.

Transition provisions of Indian Accounting Standard provides an option to a first-time adopter at the date of transition to continue with carrying value of PPE measured as per previous GAAP and use it as deemed cost. This option was opted

by the Company and carrying value (WDV) of land as on the date of transition was considered as the deemed cost for any further accounting.

During implementation of Ind AS, subject land lease for a period of 90 years was classified as an operating lease and accordingly, carrying value of land capitalised earlier under AS 10 as on 01.04.2015 of Rs. 764 crores was shifted under the head prepaid rentals which were to be charged to expenses on straight line basis over the remaining lease period.

3. After Implementation of Ind AS 116

As per Ind AS 116, 'Leases', 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. Hence, agreement with OIIC for Paradip Refinery site land is a lease under Ind AS 116 and should be accounted for as per the provision of the standard.

As per paragraphs 22 and 23 of Ind AS 116, at the commencement date, a lessee shall recognise a right-of-use asset and a lease liability at cost.

Further, under paragraph C8 of Appendix-C of Ind AS 116, transition provisions related to leases previously classified as operating leases are provided. According to paragraph C8 (b) (ii), the lessee shall recognise a right-of-use at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to the lease recognised in the balance sheet immediately before the date of initial application. In the instant case, the land cost was classified as prepaid rentals hence, the right-of-use was recognised equal to the remaining amount of prepaid rentals as on 01.04.2019 Rs.736 crores for the remaining period of the lease, i.e., 72 years.

Besides above, to bring more clarity to the readers of the financial statements, appropriate disclosure in Note - 2 Property, Plant and Equipment has been given as below:

"Leasehold Land (included in ROU asset) includes an amount of Rs. 670.27 crore for Land Development Cost."

B. Query

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

- (i) Whether the treatment of cost of land development as leasehold land is correct or whether it should be capitalised as Property, Plant and Equipment of the Refinery.
- (ii) What should be the life of right-of-use asset created for land development expenditure?

C. Points considered by the Committee

10. The Committee notes that the basic issue raised in the query relates to accounting treatment of cost of land development incurred on leasehold land. 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, any other expenditure incurred in relation to project, accounting as per previous GAAP (viz., under Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006) and accounting as per Ind AS 17, accounting treatment on transition to Ind ASs (from Accounting Standards) and transition to Ind AS 116 from Ind AS 17, accounting for prior period errors (if any) under Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', presentation of leasehold land/right-of-use asset in the financial statements, etc. The Committee has restricted the opinion only to the accounting issues under Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' and Ind AS 116, 'Leases', and has not examined from the perspective of AS 19, AS 10 and Ind AS 17.

11. The Committee notes from the Facts of the Case that the Company conceived a project to set up Grass-root Oil Refinery for which land was taken on lease for Rs. 79 crores for a period of 90 years from OIDC. Further, since the land taken on lease was in a very low-lying area and could not be used as it is, heavy dredging and reclamation cost (consisting of land development/filling cost) was required to be incurred to increase the height of land by 4 meters approximately above the main sea level to make it ready for its intended use, i.e., for setting up of Refinery.

12. The Committee first examines whether the land development expenditure results into an asset (tangible or intangible) for the Company. In this regard, the Committee notes the definition of 'asset' and the other requirements of Ind AS 38, 'Intangible Assets' 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.”**

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

“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.”

The Committee notes from the above-reproduced requirements of Ind AS 38 that in the extant case, the land development cost although results in future economic benefits in the form of improved utility of leased land, however, it neither gives rise to a separately identifiable asset nor a resource controlled by the Company. Therefore, it cannot be recognised as an individual asset (either tangible or intangible) by the Company.

13. Now, with regard to the accounting for the land development cost in the extant case, the Committee further examines whether such costs should be included in the cost of the land or the Refinery. In this regard, 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.”**

“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.**

17 Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in Ind AS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;
- (b) costs of site preparation;
- (c) initial delivery and handling costs;
- (d) installation and assembly costs;
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)²; and
- (f) professional fees.”

The Committee notes from the above that Ind AS 16 does not prescribe as to what should constitute as a unit of measure or an item of PPE and a judgement is required to be exercised in applying the recognition criteria to an entity’s specific circumstances. Further, paragraph 16 of Ind AS 16, inter alia, states that the cost of an item of property, plant and equipment comprise 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 Committee notes that land filling/development cost in the extant case is not arising as a consequence of acquisition of land rather is post-acquisition of land which is not essential for acquisition of leased land and therefore, cannot be considered as directly attributable to acquisition of leased land. Further, the leased land, being of the nature of operating lease, cannot be considered as an item of PPE under Ind AS 16. The land development cost in the given case is, in substance, required to facilitate the construction of the Refinery and for its operations. Expenditure on land development is in the nature of site preparation costs for the Refinery and is required to be incurred in order to get future economic benefits from the Refinery Project as a whole. Although the expenditure on land development leads to increasing utility of land but the purpose of such expenditure is to use the land for the ultimate Refinery Project. Therefore, the Committee is of the view that such expenditure is in the nature of directly attributable expenditure incurred for 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 considered as directly attributable to the Refinery Project in the extant case and should be capitalised as a part of cost of the Refinery/other Refinery related plant and machinery being recognised as per the principles of Ind AS 16.

14. As far as depreciation on the land development expenditure is concerned, since the same is part of the cost of the Refinery/other Refinery related plant and machinery, 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.

² This paragraph has been subsequently revised through Companies (Indian Accounting Standards) Amendment Rules, 2022, notified vide Notification No. G.S.R 255(E) dated 23rd March, 2022 which came into force with effect from April 1, 2022.

- 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.”

From the above, the Committee notes that 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/other Refinery related plant and machinery (including the land development expenditure) 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.

15. The Committee also analyses the possibility of capitalisation of the cost of land development as part of ‘right-of-use asset/land’ under Ind AS 116, ‘Leases’. In this regard, the Committee notes the following requirements of Ind AS 116:

“22 At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability.”

“23 At the commencement date, a lessee shall measure the right-of-use asset at cost.

24 The cost of the right-of-use asset shall comprise:

- (a) the amount of the initial measurement of the lease liability, as described in paragraph 26;
- (b) any lease payments made at or before the commencement date, less any *lease incentives* received;
- (c) any *initial direct costs* incurred by the lessee; and

...”

“Initial direct costs Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease**.

From the above, the Committee notes that on initial recognition, a right-of-use asset is recognised at cost, which comprises of initial measurement of lease liability, any lease payment made at or before the commencement of lease, any initial direct cost incurred by the lessee, etc. The Committee further notes from the definition of initial direct costs that it includes only incremental costs of obtaining a lease, such as, commissions, legal fees, etc. The Committee notes from the nature of items included as a part of cost of right-of-use asset that these are generally the costs incurred to obtain the lease at or before the commencement of lease. In this context, the Committee notes that the land development cost is not an expenditure to obtain the lease or right-of-use of land; rather is an expenditure subsequent to the acquisition of right-of-use to make the land useable for the Refinery Project. Therefore, the Committee is of the view that the cost of land development in the extant case cannot be included in the right-of-use of asset as per Ind AS 116.

D. Opinion

16. On the basis of the above, the Committee is of the opinion that the expenditure on land development of leased land should be considered as directly attributable to the Refinery Project in the extant case and should be capitalised as a part of cost of the Refinery/other PPE being recognised as per the principles of Ind AS 16, as discussed in paragraph 13 above. Such cost cannot be included in the right-of-use of asset as per Ind AS 116 as discussed in paragraph 15 above. As far as depreciation on the land development expenditure is concerned, the same being part of the cost of the Refinery/other Refinery related plant and machinery should be depreciated as the cost of Refinery/other Refinery related plant and machinery, considering the depreciation provisions as per Ind AS 16, as discussed in paragraph 14 above.
