

## ***Query No. 15***

***Subject: Classification of PPE under refurbishment, depreciation thereon and its impairment.<sup>1</sup>***

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

1. A Company (hereinafter referred to as 'the Company') is a Central Public Sector Undertaking in India under the administrative control of the Department of Fertilizers, Ministry of Chemicals and Fertilizers. The Company was incorporated in December 1966 as a joint venture between the Government of India (GOI) and ABC India Incorporation of USA with the GOI holding 51% of the equity share capital. The Company is engaged in the manufacture of ammonia, urea and complex fertilizers.

2. The production units of the Company consist of Ammonia and Urea in single stream and Nitrogen, Phosphorus and Potassium (NPK) in three streams, viz. NPK A Train, B Train and C Train. The Company has commenced its commercial production in 1971, with an annual installed capacity of 2,47,500 Metric Tonnes (MT) of Ammonia, 2,92,050 MT of Urea and 5,40,000 MT of NPK. A major revamp/expansion was carried out in 1998 at a cost of ₹ 601 crore, enhancing the annual installed capacity to 3,46,500 MT of Ammonia, 4,86,750 MT of Urea and 8,40,000 MT of NPK.

3. The querist has stated that NPK A, B and C trains of the Company have an installed capacity of 2.8 lakh Metric Tonnes per Annum (MTPA) each. NPK A and B trains which have an installed capacity of 5.6 lakh MTPA are not in operation from 2005 (i.e., more than 15 years) due to technical issues, non-availability of raw materials and shortage of manpower. Currently, they are not in immediate use condition due to technical obsolescence arising from change in the production process.

4. As per the Company's accounting policies, the estimated useful life of plant and machinery is 25 years. Post-revamp, the NPK A and B trains are used hardly for 7 years and thereafter they became idle. Accordingly, the Board of Directors of the Company at 314<sup>th</sup> Board meeting held on 09<sup>th</sup> November 2020, has made the revision of the installed capacity of NPK A, B and C from 8.4 lakh MTPA to 2.8 lakh MTPA, by making a note as under:

“Further, both the trains of A & B are not in line for more than 15 years and are not in immediate use condition. Hence until these trains are revived for usability, it is proposed to revise the Installed Capacity of NPK Complex from 8.4 lakh MTPA to 2.8 lakh MTPA taking into account only the Train C which is in operation.”

5. The querist has further stated that the Company has a plan of refurbishing the NPK A and B trains in order to bring the viability of the said trains. In the financial statements of the Company for the year ended 31<sup>st</sup> March 2021, consequent to the Board approval, the Company has withdrawn the assets belonging to NPK A and B trains from the Property, Plant and Equipment (PPE) with effect from 01<sup>st</sup> April 2020 and classified under Capital work in progress (CWIP). The same will be re-inducted to PPE once these are refurbished and in ready-to-use condition.

Due to classification of the assets of NPK A and B train from PPE to CWIP, the Company has ceased the depreciation of the said assets from 01<sup>st</sup> April 2020 onwards.

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<sup>1</sup> Opinion finalised by the Committee on 15.7.2022.

The carrying cost of assets in the NPK A and B trains as on 31<sup>st</sup> March, 2020 is Rs. 2.22 crore, which has been classified as CWIP in the financial statements of the Company for the year ended 31<sup>st</sup> March 2021.

6. During the audit of annual accounts of the Company for the financial year (F.Y.) 2020-21, the Comptroller and Auditor General of India (C&AG) has made a provisional comment on the said classification, which is reproduced below:

“1.5 Assets- Property Plant and Equipment – Rs. 188.39 crore

Reference is invited to Note No. 30.6 attached to and forming part of Standalone Ind AS Financial Statements for the year 2020-21, wherein it was stated that the Company removed Trains A and B of NPK plant from ‘Property Plant and Equipment’ as the assets are not in operation since 2005. The Board of Directors in their 314<sup>th</sup> Meeting held on 9<sup>th</sup> November 2020, revised the installed capacity of NPK plant from 8.40 lakh MT per annum to 2.80 lakh MT per annum until these trains are revived for usability. On the basis of the above Board decision dated 9<sup>th</sup> November 2020, the carrying cost (Net Assets Value) of these assets as of 01.04.2020 (Rs. 2.22 crore) is reclassified under ‘Capital Works in Progress’ and therefore the Company did not provide for depreciation on the assets during 2020-21.

According to Indian Accounting Standard (Ind AS) 16, depreciation does not cease when an asset is idle or retired from use for sale (unless it is fully depreciated). (Taxmann Students’ Guide to Ind AS 6<sup>th</sup> Edition). Further, there is no provision in Ind AS to transfer a PPE to CWIP. As such, transferring the Trains A and B of NPK plant to CWIP and failure to provide depreciation is in contradiction to Ind AS.

This has resulted in understatement of Property, Plant and Equipment by Rs. 1.46 crore and understatement of depreciation by Rs. 0.76 crore with corresponding overstatement of capital work in progress by Rs. 2.22 crores.”

*Reply to C&AG by Company:*

7. The reply of the Company as submitted to the C&AG is as under:

“The Board of Directors in their 314<sup>th</sup> Board Meeting revised the installed capacity of NPK production from 8.40 lakh MTPA to 2.80 lakh MTPA by withdrawing NPK A & B Plant from operation.

Further it is decided to operate the NPK A & B Train after refurbishing.

Ind AS is not specifically mentioning any accounting treatment for transfer from PPE to CWIP.

NPK A and B Plant is withdrawn from operation temporarily, hence, the same cannot be classified under PPE. Further, the assets are not scrapped, only withdrawn for refurbishment and subsequent use. The refurbishment expenditures are in capital nature. Hence the withdrawn assets are reclassified as CWIP.

The NPK A and B Plant was not in use since 2005 and hence was transferred to CWIP during the year and hence it was decided not to provide depreciation during the year.”

*Reply by the Statutory Auditors of the Company:*

8. Further, the statutory auditors of the Company have supplemented the reply made by the Company which is as follows:

“To Supplement, attention is invited to paragraph 67 of Ind AS 16, which states that the carrying amount of an item of property, plant and equipment shall be derecognised either on disposal or when no future economic benefits are expected from its use or disposal. Accordingly, the two assets namely NPK A & B Trains are not in active use since 2005 and no economic benefits accrue to the Company. These are therefore rightly removed from the PPE.

As per Ind AS 105, ‘Non-Current Assets Held for Sale and Discontinued Operations’, the carrying amount of property, plant and equipment retired from active use is to be classified as held for sale only when the intention of the management is to dispose of the assets within the stipulated time schedule. But it is clear from the resolution passed in their 314<sup>th</sup> Board Meeting held on 9<sup>th</sup> November, 2020 that the management has decided to revive the assets for usability. Since the intention is not to sell, grouping under ‘Assets Held for Sale’ does not arise.

In the absence of any specific date adopted by the Board for reclassification of the asset, it was presumed that the de-recognition of NPK train A & B and depreciation thereon will cease from 01<sup>st</sup> April 2020, due to non-operation of said trains since 2005 onwards.

Being non-current assets, Ind AS 1, ‘Presentation of Financial Statements’ permits grouping under alternative description as long as the intention of the management is clear. Paragraph 67 of Ind AS 1 is reproduced below for ready reference:

“67 This Standard uses the term ‘non-current’ to include tangible, intangible and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions as long as the meaning is clear.”

In view of above, the classification done by the Company as permitted by Ind AS 1 is more appropriate and justified.”

9. The C&AG has not dropped the observation based on reply submitted by the Company and statutory auditors. They retained the comment under section 143(6)(b) of the Companies Act, 2013 on the accounts of the Company for the year ending 31<sup>st</sup> March 2021, which is as reproduced below:

“A. Comments on Financial Position:

Assets

Capital Work in Progress (Note-2.2): – Rs. 17.78 Cr.

The above includes an amount of Rs. 2.22 crore being the net carrying value of Train ‘A’ and ‘B’ of NPK Plant due to derecognition of these assets from ‘Property, Plant and Equipment (Note-2)’. These assets were not in operation since the year 2005. These assets were not scrapped and were only withdrawn for refurbishment and subsequent use. No depreciation was charged by the Company on these assets during 2020-21. Company revised the installed capacity of NPK Plant from 8.40 lakh MT per annum to 2.80 lakh MT per annum until these trains of NPK Plant are revived for usability.

Ind AS 16 states that depreciation does not cease when an asset is idle or retired from active use unless the asset is fully depreciated. Further, other factors such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefit that might have been obtained from the asset. Thus, the de-recognition of assets from 'Property, Plant and Equipment' and accounting these under 'Capital Work in Progress' and non-provision of depreciation on such assets, is not in compliance to provisions of Ind AS.

This has resulted in understatement of net carrying value of 'Property, Plant and Equipment' by Rs. 1.46 crore, understatement of 'Depreciation' for the year by Rs. 0.76 crore with corresponding overstatement of 'Capital Work in Progress' by Rs. 2.22 crore."

## **B. Query**

10. On the basis of the above, the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) has been sought by the querist on the following issues:

- (i) Whether accounting treatment followed by the Company with reference to classification from PPE to CWIP and cessation of depreciation is correct and in accordance with Ind AS.
- (ii) In case the accounting treatment followed by the Company is correct, then how the presentation of CWIP is to be made in accordance with Schedule III to the Companies Act, 2013, as amended by MCA Notification dated 24<sup>th</sup> March 2021?
- (iii) In case the assets are to be shown under PPE, whether impairment is to be recognised.

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

11. The Committee notes that the basic issue raised in the query relates to classification of PPE under refurbishment, depreciation thereon and its impairment. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for refurbishment, appropriateness of the accounting done at the time of major revamp/expansion carried out in 1998, appropriateness of the estimation of the useful life of PPE and other aspects of depreciation, detailed aspects of impairment, accounting adjustments on transition to Ind ASs, accounting for the adjustments (if any) as per the requirements of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' etc. The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time.

12. The Committee notes from the Facts of the Case that the querist has stated that NPK A and B plants/trains are not in operation for more than 15 years due to technical issues, non-availability of raw materials and shortage of manpower; and currently, are not in immediate use condition due to technical obsolescence arising from change in production process. The Company now, has a plan of refurbishing the NPK A and B trains in order to bring the viability of the said trains. Therefore, the Company has withdrawn the assets belonging to NPK A and B trains from the Property, Plant and Equipment (PPE) with effect from 01<sup>st</sup> April 2020 and classified under Capital work in progress (CWIP). As per the querist, the same will

be re-inducted to PPE once these are refurbished and in ready to use condition. Further, due to classification of the assets of NPK A and B train from PPE to CWIP, the Company has ceased the depreciation of the said assets from 01<sup>st</sup> April 2020 onwards.

13. At the outset, the Committee notes that a non-current asset is to be classified as held for sale as per Ind AS 105, if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Therefore, NPK A and B plants, whose carrying amount shall be recovered through continuing use although after refurbishment, cannot be considered as non-current assets (or disposal group) held for sale and accordingly, the requirements of Ind AS 105 are not applicable in the extant case.

14. Further, the refurbishment cost on the existing plants, being in the nature of subsequent cost/expenditure, the Committee notes the following requirements of Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment', in respect of subsequent costs:

“10 An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. The cost of an item of property, plant and equipment may include costs incurred relating to leases of assets that are used to construct, add to, replace part of or service an item of property, plant and equipment, such as depreciation of right-of-use assets.”

#### **“Subsequent costs**

12 Under the recognition principle in paragraph 7, an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.

13 Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a nonrecurring replacement. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard (see paragraphs 67–72).

14 A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any

remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.”

From the above, the Committee notes that in case of subsequent expenditure involving replacement or major inspections/servicing/repair of an item of PPE, where such subsequent expenditure meets the recognition principle in paragraph 7 of Ind AS 16, the Standard only requires to derecognise the carrying amount of previous inspection cost or existing item or part of PPE being replaced or as per the requirements of paragraphs 67 to 72 and nowhere requires to transfer or classify such an item of PPE on which subsequent expenditure is being incurred as ‘capital work in progress’ or any other classification.

15. The Committee further notes the following paragraphs of Ind AS 16 relating to derecognition of PPE:

**“67 The carrying amount of an item of property, plant and equipment shall be derecognised:**

**(a) on disposal; or**

**(b) when no future economic benefits are expected from its use or disposal.**

**68 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless Ind AS 116, *Leases*, requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.”**

“69 The disposal of an item of property, plant and equipment may occur in a variety of ways (eg by sale, by entering into a finance lease or by donation). The date of disposal of an item of property, plant and equipment is the date the recipient obtains control of that item in accordance with the requirements for determining when a performance obligation is satisfied in Ind AS 115. Ind AS 116 applies to disposal by a sale and leaseback.”

From the above, the Committee notes that an item of PPE shall be derecognised only on disposal or when no future economic benefits are expected from its use or disposal. However, in the extant case, the Company intends to re-induct the plants after refurbishment and thus, it cannot be considered that no future economic benefits are expected from their use (though after refurbishment only). Further, since there is no disposal of the plants, the Committee is of the view that the said items of PPE cannot be derecognised and these should continue to be recognised as PPE in the financial statements.

16. With regard to cessation of depreciation, the Committee notes the following paragraphs from Ind AS 16:

“55 Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105 and the date that the

asset is derecognised. *Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated.* However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

(Emphasis supplied by the Committee.)

- 56 The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:
- (a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.
  - (b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.
  - (c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.
  - (d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.”

From the above, the Committee notes that considering that Ind AS 105 is not applicable in the extant case, as discussed above, depreciation of the plants should cease only on the date the plants are derecognised. However, since derecognition conditions as per Ind AS 16 are not fulfilled in the extant case, the depreciation on this ground also should not cease. This is also supported by the requirements of paragraph 55 of Ind AS 16, which specifically states that *depreciation does not cease when the asset becomes idle or is retired from active use, (which appears to be the situation in the extant case) unless the asset is fully depreciated.* Further, the Standard also states that technical or commercial obsolescence and wear and tear while an asset remains idle, also result in the diminution of the economic benefits and useful life of an asset and therefore, depreciation should be provided considering these factors as well.

17. With regard to impairment, the Committee notes the following requirements of Ind AS 16 and Ind AS 36, ‘Impairment of Assets’:

*Ind AS 16*

**“Impairment**

- 63 To determine whether an item of property, plant and equipment is impaired, an entity applies Ind AS 36, *Impairment of Assets*. That Standard explains how an entity reviews the carrying amount of its assets, how it determines the recoverable

amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss.”

*Ind AS 36*

**“9 An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.”**

**“12 In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:**

...

**(e) evidence is available of obsolescence or physical damage of an asset.**

**(f) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.<sup>2</sup>**

...”

**“17 If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value for the asset needs to be reviewed and adjusted in accordance with the Standard applicable to the asset, even if no impairment loss is recognised for the asset.”**

The Committee notes that Ind AS 36 does not make any exception for the asset being idle or retired from active use. Further, availability of evidence of any obsolescence or the asset becoming idle or plans to restructure provide an indication of impairment. Since in the extant case, the assets (NPK A & B plants/trains) are not in operation for more than 15 years due to various technical issues and are not in immediate use condition due to technical obsolescence arising from change in the production process, the Committee is of the view that these provide indication that these assets may be impaired. Therefore, the same should be assessed by the Company for impairment of assets, as per the requirements of Ind AS 36. Further, these factors may also provide an indication of revision of useful lives of these assets, determined as per the requirements of Ind AS 16.

#### **D. Opinion**

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

- (i) The accounting treatment followed by the Company with regard to classification of PPE under refurbishment as CWIP and cessation of depreciation is not correct as discussed in paragraphs 13 to 16 above.

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<sup>2</sup> Once an asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale), it is excluded from the scope of this Standard and is accounted for in accordance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*.

- (ii) In view of (i) above, answer to this question does not arise.
- (iii) Since in the extant case, the assets (NPK A & B plants/trains) are not in operation for more than 15 years due to various technical issues and are not in immediate use condition due to technical obsolescence arising from change in the production process, these provide indication that these assets may be impaired. Therefore, the same should be assessed by the Company for impairment of assets, as per the requirements of Ind AS 36, as discussed in paragraph 17 above.
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