

Query No. 19

Subject: *Timing of capitalisation of Lignite Handling System and depreciation thereon.*¹

A. Facts of the Case

1. Government of Rajasthan (GoR) had decided to set up lignite based mining cum thermal power plant in the private sector. In pursuance to this, an Implementation Agreement (IA) dated 29th May, 2006 was signed between GoR and J Ltd. As per IA, the power plant was to be established and maintained by J Ltd. and for mining component, a Joint Venture Company was to be formed with participation of R Ltd. (which is the undertaking of the GoR) and J Ltd. Accordingly, a Company (hereinafter referred to as 'the Company') was incorporated as a Joint Venture Company between R Ltd. (which is an undertaking of GoR) and J Ltd. wherein R Ltd. holds 51% shares and J Ltd. holds 49% shares.

2. The Company is engaged in mining of lignite from Kapurdi and Jalipa Lignite Mines at Barmer and supplying it to J Ltd. Power Plant as per Fuel Supply Agreement (FSA) entered between J Ltd. and the Company on 19th January, 2011. Lignite is being transported to the power plant from Kapurdi Mines by 4.5 km covered conveyor belt. 2.5 Km pipe conveyor for the transportation of lignite from Jalipa Mines to power plant was commissioned during the financial year (F.Y.) 2020-21.

3. The querist has given a brief chronology of the facts of the case as under:

S.No.	Particulars/Facts	Date/Completion schedule
1.	Tender date	27 th December, 2017
2.	Effective Date of Contract	Date of receipt of the Letter of Award
3.	Date of Letter of Award (LOA)	1 st November, 2018
4.	Date of Contract	04 th January, 2019
5.	Completion Schedule	15 Months from Effective date of contract (i.e. 31 st January, 2020)
6.	Crushing and transportation of Lignite started from one stream	30 th September, 2020
7.	Stream 1 Commissioning Date (SMC 01 to VF 03) (as per Commissioning Certificate dated 22 nd January, 2021)	16 th October, 2020
8.	Company has started to dispatch entire Lignite through Lignite Handling System, both the streams were operative	19 th December, 2020
9.	Commissioning of complete project (as per Commissioning Certificate dated 22 nd January, 2021)	31 st December, 2020
10.	Performance Guarantee Test	23 rd February, 2021
11.	Taking Over of Plant	1 st March, 2021
12.	Date of capitalisation in books of account	1 st March, 2021

¹ Opinion finalised by the Committee on 11.10.2022.

4. The tender for setting up 6.0 MTPA Lignite Handling System from Jalipa Mines to J Ltd. on Engineering, Procurement and Construction (EPC) basis to size and transport lignite mined from mines was floated on 27th December, 2017.

5. On the basis of technical evaluation of bids and price quoted by bidders, a Letter of Award (LOA) was issued in favor of F Ltd., vide letter dated 01st November, 2018. F Ltd. submitted its comments on the Letter of Award vide letter dated 8th November, 2018.

6. Subsequently, the Contract Agreement between the Company and F Ltd. was signed on 4th January, 2019 (A copy of the contract agreement has been supplied separately by the querist for the perusal of the Committee).

7. As per clause 3 of LOA, the 'Effective Date of the Contract' shall be the date of receipt of the LOA and as per clause 5 of the LOA, the commissioning of all the equipment under scope of work shall be completed within 15 months from the effective date of the contract or such extended time as may be allowed in terms of the tender document. Accordingly, as per LOA, the date of commissioning of the project is to be considered as 31st January, 2020.

8. The Company has started crushing and transportation of lignite through one stream w.e.f. 30th September, 2020 and from 19th December, 2020 both the streams were operative and the Company has started to dispatch entire lignite through Lignite Handling System.

9. The querist has given the details of the dispatch from the month of September, 2020 upto March, 2021 hereunder:

S. No.	Month	Dispatch quantity by Road (In MT)	Dispatch quantity by Conveyor (In MT)	Total Dispatch (In MT)
1.	September, 2020	1,00,033.90	1,101	1,01,134.9
2.	October, 2020	77,108.15	63,504	1,40,612.15
3.	November, 2020	68,527.90	1,14,258	1,82,785.90
4.	December, 2020	32,563.73	1,75,768	2,08,331.73
5.	January, 2021	-	1,87,395	1,87,395
6.	February, 2021	-	2,11,545	2,11,545
7.	March, 2021	-	2,54,957	2,54,957
8.	Total	2,78,233.68	10,08,528	12,86,761.68

10. The project was declared commissioned on 31st December, 2020 (after time extension). Commissioning Certificate dated 22nd January, 2021 specifies the date of completion of the project as under:

1. SMC-01 to VF-03 - 16th October, 2020
2. SMC-02, VF-02 to JC-04 - 31st December, 2020

11. The Performance Guarantee Test was demonstrated successfully achieving all the parameters as defined in the tender conditions on 23rd February, 2021. Taking over of the Lignite Handling System was done on 01st March, 2021.

12. The Company has accordingly capitalised the Lignite Handling System w.e.f. 01st March, 2021, i.e. from the date of taking over (i.e. when the risks and rewards of the plant were transferred to the Company) and has charged the depreciation accordingly.

13. Supplementary audit of the financial statements for the financial year (F.Y.) 2020-21 by the Office of Comptroller and Auditor General of India (C&AG) was held for the period from 04th March, 2022 to 11th March, 2022. During the audit, a para was issued. The para relates to the date of capitalisation and charge of depreciation of the Lignite Handling System.

14. The Company has capitalised and charged depreciation w.e.f. 01st March, 2021 (i.e. the date of taking over, when the risks and rewards of the plant were transferred to the Company), whereas office of C&AG expressed their opinion to charge depreciation w.e.f. 01st Janaury, 2021 (i.e. the date of commissioning).

B. Query

15. In view of above, the opinion of Expert Advisory Committee is sought as to whether the Company is correct in capitalising and charge of depreciation on the Lignite Handling System with effect from 01st March, 2021 (i.e. the date of taking over) or as per the views of office of C&AG, the Company should capitalise the Lignite Handling System with effect from 01st Janaury, 2021 (i.e. the date of commissioning).

C. Points considered by the Committee

16. The Committee notes that the issues raised by the querist relate to (i) the timing of capitalisation of the lignite handling system and (ii) timing of depreciation thereon. The Committee has, therefore, considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, accounting for joint venture arrangement, accounting in the books of joint venturers, accounting for lignite dispatched through lignite handling system etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from legal perspective, such as, legal interpretation of various documents submitted by the querist such as tender document, letter of award, commissioning certificate, performance guarantee test report, taking over certificate, etc. Further, the Committee wishes to point out that the Indian Accounting Standards referred to in the Opinion are the Standards notified under the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

17. At the outset, the Committee wishes to mention that recognition of an asset in the financial statements is determined by the criterion of 'control' over the economic resource as per the Conceptual Framework for Financial Reporting under Indian Accounting Standards (Ind AS), issued by the Institute of Chartered Accountants of India; accordingly, ownership or transfer of risks and rewards as stated by the querist are not the sole determining factors for recognition of an asset, such as an item of property, plant and equipment (PPE). The Committee is further of the view that where an accounting standard prescribes specific requirements on a particular aspect, those specific requirements are required to be considered. Accordingly, since Ind AS 16, as discussed below, prescribes specific requirements as to timing of capitalisation of PPE including accounting for self-constructed asset (PPE), the same needs to be considered for deciding the timing of capitalisation of the asset in the extant case.

18. The Committee notes that the issue to be examined in the extant case is when the Lignite Handling System or any section/stream or part thereof can be considered as an item of 'Property, Plant and Equipment'. In this regard, the Committee notes the following paragraphs 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.”**

“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:

...

- (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) ...
- (f) ...”

“20 *Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management.* Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

- (a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;
- ...”

“22 The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see Ind AS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset

is not included in the cost of the asset. Ind AS 23, *Borrowing Costs*, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.”

(Emphasis supplied by the Committee)

The Committee notes from the above that recognition of costs in the carrying amount of an item of PPE should cease when an item is *in the location and condition necessary for it to be capable of operating* in the manner intended by management, even though there is a possibility of the item operating at less than full capacity. Further, since cost of testing whether the asset is functioning properly is also an example of directly attributable cost, an asset cannot be considered to be *in the location and condition necessary for it to be capable of operating* in the manner intended by management unless the testing of an asset as per the requirements of the Standards is completed.

The Committee is of the view that normally, the purpose of testing or test runs is to ensure that the asset is functioning properly, i.e., technical and physical performance (and not financial performance) of the asset, as expected for its intended use, is ensured. During test runs, if there are technical deficiencies/problems, adjustments are made and problems are rectified to ensure that the asset is ready for its intended use, i.e., capable of operating in the manner intended by the management. Therefore, before completion of such test run, the plant/asset cannot be considered to be in the location and condition necessary for it to be capable of operating in the manner intended by management as per the requirements of Ind AS 16.

19. In this regard, the Committee notes from the Facts of the Case that the querist has stated that 2.5 km pipe conveyor for the transportation of lignite from Jalipa mine to power plant was commissioned during F.Y. 2020-21. Crushing and transportation of lignite through one stream started from 30.09.2020 and from 19.12.2020, both the streams were operative and the Company started to dispatch lignite through lignite handling system. Thereafter, the project was declared commissioned on 31.12.2020 and commissioning certificate dated 22.01.2021 specified date of completion of project as 16.10.2020 (for SMC-01) and 31.12.2020 (for SMC-02). After that, performance guarantee test was performed on 23.02.2021 and taking over of the lignite handling system was done on 01.03.2021 and the Company capitalised the lignite handling system w.e.f. 01.03.2021.

20. The Committee further notes from the scope of work of the contract between the Company and the Contractor (F Ltd.) for setting up of Lignite Handling System that in the extant case, various tests are being conducted, such as, no load test, load test, commissioning test, reliability test, performance test/performance guarantee test by the contractor (F Ltd.) before the system is finally taken over by the Company. The Committee is of the view that the duration of trial run and the date or point of time when an asset can be considered to be in the location and condition necessary for it to be capable of operating in the manner intended by the management as per the requirements of Ind AS 16 is a matter of technological assessment and judgement, which the Company should exercise itself in its specific facts and circumstances, considering various factors such as, technological parameters, safety parameters, etc. in order to ensure that the asset is functioning properly in terms of technical and physical performance. It is for the Company to identify technologically that at what stage or after what level of testing can the asset be considered to be in the location and condition necessary for it to be capable of operating in the manner intended by the management. However, if the purpose of conducting any test is to achieve a certain level of capacity and not

to ensure any technical/physical performance of the asset, that test should not be considered to determine the date or point when an asset can be considered to be in the location and condition necessary for it to be capable of operating in the manner intended by the management.

21. In this context, the Committee wishes to mention that while determining such a date or a point of time, the manner of operation intended by the management or, in other words, the intended use of an item of PPE (acquired or constructed) should also be taken into consideration. Thus, after acquisition/construction of any equipments/PPE/units which are part or components of a larger and integrated PPE/project, if these are not capable of operating due to other units or remaining facilities being under development or construction and cannot be operated independently, those equipments/PPE cannot be considered to be in the location and condition necessary for them to be capable of operating in the manner intended by the management, as per the requirements of Ind AS 16. Conversely, if a part or unit is capable of being used while construction continues on other parts, that part or unit should be capitalised as PPE and depreciated accordingly, as per the requirements of Ind AS 16. In this regard, the Committee notes that in the extant case, crushing and transportation of lignite through one stream started from 30.09.2020 and from 19.12.2020, both the streams were operative. It indicates that both the streams were capable of being operated independently. Further, it also indicates that the test runs to ensure that both streams (assets) were functioning properly in terms of technical and physical performance, might have been completed for the respective stream(s). Accordingly, from their respective dates of commissioning, the concerned assets may be considered to be in the location and condition necessary for them to be capable of operating in the manner intended by the management, as per the requirements of Ind AS 16.

The Committee also wishes to mention that to determine when an item of PPE can be capitalised, it is the date when the asset or part thereof is in the location and condition necessary for it to be capable of operating in the manner intended by the management of the Company, which is important and not the date of any certificates issued by the Company (which is the owner of lignite handling system), to the Contractor.

22. Further, with regard to the issue raised in the facts relating to commencement of depreciation, the Committee notes paragraph 55 of Ind AS 16 as follows:

“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.”

From the above, the Committee notes that depreciation of an asset should commence from the date the asset is available for use, i.e., when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by the management.

D. Opinion

23. On the basis of above, the Committee is of the opinion on the issues raised in paragraph 15 above that the date or point of time when an asset can be considered to be in the location and condition necessary for it to be capable of operating in the manner intended by the management as per the requirements of Ind AS 16 is a matter of technological assessment and judgement, which the Company should exercise itself in its specific facts and circumstances, considering various factors such as, technological parameters, safety parameters, etc. in order to ensure that the asset is functioning properly in terms of technical and physical performance, as discussed in paragraphs 20 and 21 above. Further, depreciation should commence when the asset is available for use, i.e., when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by the management, as discussed in paragraph 22 above.
