

Query No. 24

Subject: Timing of capitalisation of irrigation assets.¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’) is wholly owned by the Government of Karnataka and is formed for the purpose of completion of the irrigation projects in the Krishna river basin of Karnataka. The Upper Krishna Project is one of the major projects being implemented by the Company. The Project is being implemented in several stages. The Stage I and Stage II of the Project have been completed and fully capitalised in the books of account prior to the Company transited to the Indian Accounting Standards (Ind AS).

2. The Stage III of the Project is under implementation to utilise 130 Thousand Million Cubic Feet (TMC) of water allocated to Upper Krishna Project (UKP) under the Inter State Water Disputes Tribunal – II award. The notification of the award of the Krishna Water Dispute Tribunal is still awaited from the Government of India, as some of the riparian states have approached the Hon`ble Supreme Court for modification of the allocation. However, the Government of Karnataka has issued an administrative order to implement the Project.

3. The expenditure incurred on the Project was being continued till the year 2018-19 under Capital Work-in-Progress (CWIP), as the storage of water could not be accomplished and let out in the canal systems due to the litigation pending before the Hon`ble Supreme Court and awaiting notification of the Krishna Water Disputes Tribunal (KWDT) award. Meanwhile, some stretches of the canals were being completed and they were into maintenance period. The Government of Karnataka had been requested to take a legal opinion from the Advocate General of Karnataka regarding legal impediments, if any, in capitalising the UKP Stage III completed canals. The Government communicated the opinion of the Advocate General, Karnataka, according to which there were no legal impediments to capitalise the UKP Stage III assets.

4. Based on the legal opinion of the Advocate General, the Company started capitalising the UKP Stage III assets to the extent they were completed and for which completion certificates have been issued by the Chief Engineer of the respective projects.

5. The components of an irrigation project comprises of (1) the head works of Lift Irrigation Scheme, including civil and electro mechanical components to pump water into the canal system (2) Canal System comprising of (i) Main Canals (ii) Distribution Canals (iii) Lateral Canals (iv) Minors and ultimately, (v) Field Irrigation Canals (FICs) which actually carry water to the agricultural fields of the farmers.

6. Prior to implementation of Ind AS, the Company was capitalising the canals only when they were substantially completed and put to use. In order to assess the stage of completion for the purpose of capitalisation then, the Company had evolved a policy that if the project had achieved 90% of the contemplated irrigation potential it would be capitalised. Till then, the expenditure was being carried under capital work-in-progress.

7. The Company is implementing canal networks comprising of (i) Main Canal (ii) Distributaries (iii) laterals (iv) Minors and (v) Field Irrigation Canals (FIC) to convey water to

¹ Opinion finalised by the Committee on 13.12.2022.

the farmers. The FICs are the end stage of the canal system which actually carry water ultimately to the farmer's field. As the canals including all its subsidiary conveyance network is very lengthy and to facilitate speedy implementation, tenders are awarded in shorter stretches. Tenders for the work may or may not be awarded simultaneously and in chronological order as the water flows. As such, in a canal network, some of the stretches may be completed and completion certificate is issued. For instance, while in a canal network, the stretch from Km 1 to 10 of main canal may be completed, the balance canal system in Km 10-20 or its distributary, laterals and field irrigation canals may not be completed and ready for ultimate use of the water by the farmer. Similarly, a farther stretch of canal say 10 Km to 20 Km may be completed and ready to use, but the prior reach from Km 0 to 10 may not be ready. All these canals could be put to ultimate use only when the field irrigation canals are completed and the whole canal system is completed and ready for use. However, in reality, it takes many years before the FICs are completed and the entire canal system is put to use, even though, the lift irrigation system (water lifting machinery and related infrastructure), main canals and distributor canals are ready and in place for intended use.

8. The querist has stated that Indian Accounting Standard (Ind AS) 16, 'Property, Plant and Equipment' stipulates that the cost of an item of property, plant and equipment should 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.

Further, with regard to fulfillment of recognition criteria, the querist has stated as follows:

- a) Regarding the criteria of future economic benefits, the water rates on water let out to farmers (revenue to the Company) can be realised by the Company only when the water is let out to the farmers in the field irrigation canals.
- b) Regarding criteria of the measurement of cost, the same is the historic expenditure, incurred on the construction of the canals and hence capable of being measured reliably.

9. The Company is of the view that the canal system completed is physically in a usable condition, the only impediment for its non-usage is that the canal system in the initial part is not complete and hence water cannot be made to flow through it. Since for a stretch of the canal system, the completion certificate has been issued, it is in the location and condition necessary for the intended use, and the same can be deemed to be available for use. Further, the stretches of the completed canals are subject to the normal wear and tear as they are open to elements and their condition deteriorates due to the long gestation before the field irrigation canals are completed. Accordingly, the Company has been in the practice of capitalising the irrigation system, based on the works completion certificates issued for each component or stretch of the canals independently and claimed depreciation keeping in view paragraph 55 of Ind AS 16.

B. Query

10. In view of above, opinion of the Expert Advisory Committee is sought as to whether it is appropriate to capitalise the irrigation assets comprising the water lifting system and canals, prior to completion of the Field Irrigation Canals based on completion certificates issued in respect of individual component of the canal system. If not, what is the criteria to be adopted?

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to the timing of capitalisation of various irrigation assets comprising the water lifting system and canals under Stage III of UKP, prior to completion of entire network of the Field Irrigation Canals. The Committee has, therefore, examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for various expenditure under Stage I and Stage II of the Project, appropriateness of the accounting policy regarding capitalisation, detailed aspects of depreciation accounting, accounting before transition to Ind ASs and accounting during transition, etc. Further, the Committee wishes to point out that the Standards hereinafter referred are the Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time. Furthermore, the opinion expressed hereinafter is purely from accounting perspective and not from legal perspective including legal interpretation of the opinion of the Advocate General, Karnataka, administrative order of the Government of Karnataka, status of the pending litigation before the Hon'ble Supreme Court etc.

12. With regard to the issue raised, 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.”**

“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.”**

“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.”**

- “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;
 - (b) initial operating losses, such as those incurred while demand for the item’s output builds up; and
 - (c) costs of relocating or reorganising part or all of an entity’s operations.”
- “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.”

The Committee notes from the above that recognition of costs in the carrying amount of an item of property, plant and equipment (PPE) (including self-constructed asset) should cease at the time when an item is *in the location and condition necessary for it to be capable of operating* in the manner intended by management. Thus, from such point in time, the item under construction should be transferred from capital work in progress to the gross block of PPE. The Committee is of the view that the point in time when an asset is *in the location and condition necessary for it to be capable of operating* in the manner intended by management is a question of fact which should be determined in the specific facts and circumstances on the basis of various factors, such as, technological evaluation of the readiness of the asset, completion of test runs to ensure that the asset is functioning properly etc. The Committee further notes that what is important is when the asset is *in the location and condition necessary for it to be capable of operating* in the manner intended by management and not the intended capacity to be achieved.

13. In this regard, the Committee also notes paragraphs 24 and 25 of Indian Accounting Standard (Ind AS) 23, ‘Borrowing Costs’, notified under the Companies (Indian Accounting Standards) Rules, 2015, which although addresses the issue from the point of view of the borrowing costs, however, the Committee is of the view that the principle enunciated in these paragraphs can be applied to other expenditures also. Paragraphs 24 and 25 of Ind AS 23 are reproduced below:

- “24 When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.**

- 25 A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.”

From the above, the Committee is of the view that in case of an integrated PPE/project having several units/parts, those units/parts of the PPE/project which are capable of being usable while the construction continues for the other units/parts and can be operated independently of the remaining units/parts, should be considered to be *in the location and condition necessary for it to be capable of operating* in the manner intended by management and should be capitalised as PPE.

14. In this context, the Committee notes from the Facts of the Case that the Company is executing irrigation project comprising of (1) the head works of Lift Irrigation Scheme, including civil and electro mechanical components to pump water into the canal system and (2) Canal System comprising of (i) Main Canals (ii) Distribution Canals (iii) Lateral Canals (iv) Minors and ultimately, (v) Field Irrigation Canals (FICs) which actually carry water to the agricultural fields of the farmers, which is the ultimate/intended use of the Project. The Committee further notes that Field Irrigation Canal (FIC) is the end stage of the canal system which actually carries water ultimately to the farmer’s field. It is also stated by the querist that in a canal network, some of the stretches are completed and completion certificate is issued; however, all these canals could be put to ultimate use only when the Field Irrigation Canals are completed and the whole canal system is completed and ready for use. The Lift Irrigation System (water lifting machinery and related infrastructure), main canals and distributor canals are ready and in the location and condition although it will take many years before the FICs are completed and the entire canal system is put to use, for intended use.

15. From the above, it appears to the Committee that in the extant case, the different parts/units of the project, such as, lift irrigation system, canal system and its various components, etc. are interdependent and interlinked (as being contended by the querist) making the entire irrigation project an integrated project. Further, it appears that unless FIC is completed, which ultimately carries water to the farmer’s field, the entire project is not capable of being usable, and other components/ units cannot be operated independently of the FIC. Therefore, the Committee is of the view that till FIC(s) is(are) completed, the various units/parts of the Project 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 mentioned above and accordingly, cannot be capitalised as an item of PPE. However, the Committee is of the view that in the extant case, it is possible that as soon as a section of FIC is complete and is ready (while construction of other section of FIC is being undertaken), it may enable the functioning of other inter-linked assets of irrigation project and make the entire project capable of being used, although in a limited area and not at the intended irrigation potential or capacity or catering to the entire group of intended farmers’ fields. In that case, the project to that extent may 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 and accordingly, may be capitalised as an item of PPE, only to such extent, even prior to completion of entire FICs. In this context, the Committee also wishes to point out that once the relevant assets are capitalised, depreciation should be provided on such capitalised asset(s) as per the provisions of Ind AS 16. Further, the Company should also comply with the

requirements of Ind AS 36, 'Impairment of Assets' even when the project/asset is still under construction.

D. Opinion

16. On the basis of above and as mentioned in paragraph 15 above, the Committee is of the view that in the extant case, since the irrigation project is an integrated project and unless FIC is completed, the entire project is not capable of being usable, the various units/parts of the Project cannot be considered to be in the location and condition necessary for it to be capable of operating in the manner intended by management. Accordingly, such units/parts cannot be capitalised as an item of PPE, prior to completion of the FIC(s) based on completion certificates issued in respect of individual component of the Project. However, in case, it is possible that as soon as a section of FIC is complete and is ready (while construction of other section of FIC is being undertaken), it may enable the functioning of other inter-linked assets of irrigation project and make the entire project capable of being used, although in a limited area and not at the intended irrigation potential or capacity or catering to the entire group of intended farmers' fields, the project to that extent may 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 and accordingly, may be capitalised as an item of PPE, only to such extent, even prior to completion of entire FICs. Further, the Company should also comply with the requirements of Ind AS 36, 'Impairment of Assets' even when the project/asset is still under construction, as discussed in paragraph 15 above.
