Creation of Deferred Tax Asset in Respect of Provision for Final Mine Closure Expenditure

Expert Advisory Committee

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A public sector undertaking is engaged in mining of manganese ore at several locations. Due to different chemical compositions required by end-users (mainly ferro manganese producers), ore extracted from a single mine, which has a particular chemical composition, is not sold as such; instead, blend of ore of various mines is sold.

2. The querist has stated that as per Rule 23B of Mineral Conservation and Development Rules, 1988 (MCDR) amended in April, 2003, it is obligatory on the part of the user (lessee) to submit progressive mine closure plan at the time of obtaining lease or at the time of lease renewal or, in case of continuing leases, every five years. The Indian Bureau of Mines (IBM), which is a regulatory body, is also insisting upon bank guarantees which can be invoked if activities stated in progressive mine closure plan are not carried out to their satisfaction. Further, as per Rule 23C of MCDR, it is also necessary to submit final mine closure plan one year prior to proposed closure. As per Rule 23(5) of MCDR, the leaseholder cannot abandon a mine or part thereof unless the final mine closure plan is implemented to the satisfaction of the IBM. As per the regulations, the leased area can be surrendered only after restoring the same by carrying out reclamation, surface back filling, removing dumps, plantation over waste rock dumps, etc. These activities involve substantial expenditure which is called 'final mine closure expenditure'. The querist has also submitted separately relevant extracts of the Mine Conservation and Development Rules for the perusal of the Expert Advisory Committee.

3. According to the querist, as estimated, the ore reserves in the present leases are expected to last for about 35-40 years, based on the current rate of extraction of ore. The expected year of closing down a particular mine cannot, however, be predicted based on available ore reserves because extraction rate also depends on demand of various grades of ore and blend of ore which the company decides to sell from time to time. The longevity of the mine also depends on factors like (a) technological developments in the steel industry, which may result in alternative cheaper substitute in place of manganese, and (b) identification of ore reserves at lower underground levels, which can be extracted at an economical cost.

4. As per the querist, as the final mine closure is a result of extraction of ore during the operating period of lease of a mine, it is necessary that profits of a financial year should be worked out after providing for estimated liability on account of final mine closure expenditure. In view of this and due to Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Institute of Chartered Accountants of India, becoming mandatory for accounting periods commencing on or after 01.04.2004, the company has provided for the estimated liability on account of final mine closure expenses in the financial year 2004-05 for the first time. According to the querist, mine-wise estimated expenditure on final mine closure, proven ore reserves and actual production during the year have been considered for the purpose of working out the estimated liability for final mine closure expenditure.

5. The querist has stated that the provision for final mine closure expenses is not allowable under the Income-tax Act, 1961 since the same is not incurred

during the current year. Thus, in the view of the querist, as per paragraph 4 of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India, the item falls under the category of 'timing differences' for the purpose of working out deferred tax assets.

6. According to the querist, as a matter of prudence, the company has not recognised the deferred tax assets on this account. The querist has stated that the company has considered the following aspects while taking this decision:

(a) The possibility of mine closure and, in turn, incurring restoration/reclamation expenditure will take effect not in the near future but probably after a period of 35-40 years. The mines under reference are being operated for more than 50 years and there is no event during the current year which necessitates closure of any of the mines in the near future.

(b) Although the company has been consistently reporting very good profits, it cannot be predicted whether there will be sufficient taxable income after 35-40 years (especially when large mines/all mines of the company will be closed down) to realise the deferred tax assets, if created.

(c) Possibility of the company making any profit in the year of incurrance of mine closure expenses to claim tax benefits on these expenses is an assumption, which may or may not prove to be correct.

(d) One of the major considerations governing selection and application of accounting policies is 'prudence', which stipulates that in view of uncertainty attached to future events, profits are not anticipated but recognised only when realised.

(e) It is too early to predict conditions of profitability and taxable income which would exist 35-40 years later.

7. According to the querist, paragraph 16 of AS 22 requires exercise of prudence at the time of creating deferred tax assets by taking into account past trends only. However, factors like uncertainty attached to future events, especially for fairly long periods, have not been highlighted in the Accounting Standard.

8. As per the querist, the government auditors have pointed out that the factors enumerated in paragraph 6 above have not been specified in the Accounting Standard and hence, the deferred tax asset should have been created in view of the timing differences as contemplated in AS 22. The government auditors have also taken a stand that there is a provision for reassessment of deferred tax assets at each balance sheet date in AS 22, and if it is felt later that there would not be sufficient taxable income to realise the deferred tax assets, the company can reassess the same.

9. According to the querist, in support of the treatment given by the company, it has been pointed out to the auditors that one of the major considerations governing selection and application of accounting policies is 'prudence', which stipulates that "in view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash" (paragraph 17(a) of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', issued by the Institute of Chartered Accountants of India). Therefore, the company has chosen to postpone the recognition of the deferred tax asset and to create the same only when it is absolutely sure of realising such assets.

10. The company's viewpoint has not been accepted by the government auditors and, hence, an assurance has been given by the company to seek the opinion of the Expert Advisory Committee and to review the position next year. The querist has separately provided the photocopies of the government auditors' views, explanations thereto given by the company and the final comments of the government auditors for the perusal of the Committee.

11. The querist has emphasised that the provision should not be considered for working out deferred tax assets till it is absolutely sure that the assets would be realised and/or final mine closure is foreseen in the near future.

B. Query

12. The querist has sought the opinion of the Expert Advisory Committee as to whether any deferred tax asset needs to be created as per AS 22 (especially bearing in mind the concept of prudence) in respect of provision made on account of final mine closure expenditure, which is a remote event and the expenditure is likely to be incurred after a period of 35-40 years.

C. Points considered by the Committee

13. The Committee, while expressing its opinion, has restricted itself to the issues raised in paragraph 12 above and has

not considered any other issue that may arise from the Facts of the Case such as, allowability of provision for final mine closure expenses under the Income-tax Act, 1961.

14. The Committee notes that the nature of final mine closure expenditure in the present case is similar to that of abandonment costs in case of oil and gas producing companies. In this context, the Committee notes paragraph 53 of the Guidance Note on Accounting for Oil and Gas Producing Activities, issued by the Institute of Chartered Accountants of India, which states as follows:

> "53. Abandonment costs are the costs incurred on discontinuation of all operations and surrendering the property back to the owner. These costs relate to plugging and abandoning of wells, dismantling of wellheads, production and transport facilities and to restoration of producing areas in accordance with license requirements and the relevant legislation."

15. Regarding the accounting treatment of final mine closure expenditure, the Committee notes paragraph 54 of the above-mentioned Guidance Note and Example 3 of Appendix C to AS 29 in the context of oil and gas industry, which state as follows:

Guidance Note on Accounting for Oil and Gas Producing Activities

> "54. The *full eventual liability for abandonment cost* net of salvage values should be recognised at the outset on the ground that a liability to remove an installation exists the moment it is installed. Thus, an enterprise should *capitalise as part of the cost centre* the amount of provision required to be created for subsequent abandonment. Charge for abandonment costs should not be discounted to its present value. The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, industry practice, etc." (Emphasis supplied by the Committee).

AS 29

"Example 3: Offshore Oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event – The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraph 14). These costs are included *as part of the cost of the oil rig*. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted." (Emphasis supplied by the Committee)."

16. The Committee also notes paragraphs 17 and 19 of the Exposure Draft of the Revised Accounting Standard (AS) 10, 'Tangible Fixed Assets', issued by the Institute of Chartered Accountants of India, which propose the following accounting treatment:

> "17. The cost of a tangible fixed asset comprises:
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> (a) its purchase price, including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), after deducting trade discounts and rebates.
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> (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.
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> (c) the initial estimate of the costs of dismantling and removing the asset and restoring the site on which it is located, the obligation for which an enterprise incurs either when the asset is acquired or as a consequence of having used the asset during a particular period for purposes other than to produce inventories during that period."
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> "19. The obligations for the costs of dismantling and removing the asset and restoring the site on which it is located are recognised and measured in accordance with AS 29, Provisions, Contingent Liabilities and Contingent Assets. The underlying nature and association of an obligation for dismantling, removing and restoring the site on which a tangible fixed asset is locat-

ed with the asset remains the same irrespective of whether the obligation is incurred upon acquisition of the asset or while it is being used. Therefore, the cost of an asset also includes the costs of dismantlement, removal or restoration, the obligation for which is incurred as a consequence of having used the asset during a particular period other than to produce inventories during that period. An enterprise applies AS 2, Valuation of Inventories, to the costs of obligations that are incurred as a consequence of having used the asset during a particular period to produce inventories during that period. This is because the accounting for these costs in accordance with AS 2 acknowledges their nature."

17. It appears from the Facts of the Case that the final mine closure is a result of extraction of ore during the operating period of lease of a mine, rather than the result of dismantlement of plant and equipment which is used for the purpose of extracting the ore from the mine. In view of this, creation of provision every year to the extent of the ore extracted during the year, representing the estimated liability on account of final mine closure expenses, is appropriate. However, in case a part or the whole of the final mine closure expenses relate to the dismantlement of plant and equipment used for the extraction of ore, the provision for the relevant amount should be made in the year in which the cost of acquisition/construction of plant and equipment is capitalised. In this case, the amount of the provision should be capitalised as a part of the cost of the plant and equipment, instead of the amount of provision being debited to the profit and loss account.

18. With regard to creation of deferred tax asset, the Committee is of the view that if the provision for final mine closure expenses gives rise to timing differences under AS 22, leading to creation of deferred tax asset, consideration of prudence should be kept in mind as recognised in paragraph 13 of AS 22, which states as follows:

> ***"13. Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets as set out in paragraphs 15-18."***

19. The Committee also notes that in the present case since the company under consideration is making profits, paragraphs 15 and 16 of AS 22 are also relevant for considering whether the deferred tax asset should be created or not. The said paragraphs are reproduced below:

> ***"15. ...deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.***
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> 16. While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future."

20. The Committee notes from the above that AS 22 envisages creation of a deferred tax asset if there is 'reasonable' certainty that sufficient future taxable income will be available against which such deferred tax asset can be realised rather than 'absolute' certainty as argued by the querist in paragraphs 9 and 11 above. The Committee also notes that this 'reasonable' level of certainty would normally be achieved by examining the past records of the enterprise and by making 'realistic estimate' of profits for the future. The Committee is of the view that while the realistic estimate would take account of the future uncertainties, the possibility of occurrence or non-occurrence of any unforeseen event leading to absence of sufficient future taxable income, may not be sufficient ground for not creating the deferred tax asset. This is because such unforeseen events are a part of every business. Further, it is appreciated that the longer the period for which an estimate is to be made, the lesser is the degree of accuracy of making the estimate. However, in such situations also, keeping in view the past experience of not only the company concerned but also of the industry as a whole, making of a realistic estimate may still be possible. The Committee also notes that sufficient future taxable income may also arise from the reversal of deferred tax liabilities created, for example, on account of the timing differences between the tax depreciation and the accounting depreciation. In view of this, the company should make a 'realistic estimate' of profits for the future and, if such an es-

timate can be made, create the deferred tax asset. However, in case the 'realistic estimate' indicates that there will not be any sufficient future taxable income to realise the deferred tax asset, the company should not create the deferred tax asset.

21. In a situation where the final mine closure expenses relate to dismantlement of plant and equipment and the provision therefor is capitalised as a part of the cost of the plant and equipment, there would be no timing differences on account of the provision since the same is not debited to the profit and loss account. The timing difference, if any, will arise on account of the depreciation for tax purposes and that for accounting purposes which may result into creation of deferred tax asset/liability. In case it results in a deferred tax asset situation, the considerations discussed in paragraph 20 above would apply in the creation of the deferred tax asset.

D. Opinion

22. On the basis of the above, the Committee is of the opinion that deferred tax asset may have to be created as per AS 22 in view of the considerations stated in paragraphs 17 to 21 above. ❐

Notes:

1. *The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.*
2. *The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty four volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.*

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