

Accounting Treatment of Machinery Spares Where The Principal Item of Fixed Asset has been Fully Depreciated

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. 'X', an electricity generating station, is owned by the Government of India (GOI). The management of the station has been entrusted to company 'Y' under an agreement w.e.f. 01.04.1978. The annual budget for the operation and maintenance of the station is approved by the Government and funds equivalent to the realisations from the sale of energy are provided for the same. The sales are realised either directly from a State Electricity Board which is the sole beneficiary of the plant, or through central appropriation. All such amounts are deposited into a government bank account as and when received. An equal amount is claimed from the Ministry of Power (MOP) on producing the proof of such a deposit. The amount received from the Ministry is utilised by company 'Y' to meet the operational and maintenance expenses of 'X'. A monthly statement of account, giving details of the receipts and payments of the station, is to be submitted by company 'Y' to the Government of India, which is being sent regularly.

2. The querist has stated that as per clause 5(m) of the agreement of company 'Y' with GOI, company 'Y' has to maintain separate and complete books of account in respect of all transactions of 'X' to compile balance sheet and profit and loss account to the satisfaction of GOI and to have the same audited by a chartered accountant

on an annual basis. A copy of the report of the chartered accountant on the annual accounts is to be furnished to GOI as soon as possible after the end of each financial year.

3. As per clause 5(n) of the agreement of company 'Y' with GOI, company 'Y' has to make available for the inspection of officers duly authorised by GOI in this behalf and to the Comptroller and Auditor General of India or its representatives, the books of account, supporting vouchers and other documents relating to 'X'.

4. According to the querist, 'X' is not registered under the Companies Act, 1956, and being an electricity generating station, is governed by the provisions of the Electricity (Supply) Act, 1948. 'X' generally maintains books of account on mercantile basis as per the format approved by MOP/GOI. 'X' is not preparing its financial statements in the format prescribed in Schedule VI to the Companies Act, 1956.

5. As per clause 7 of the agreement of company 'Y' with GOI, notwithstanding anything contained in the agreement, the rights, title and interest in the assets acquired or accrued shall always remain vested in GOI and not in company 'Y'.

6. The querist has stated that 'X' comprises five generating units. Units I, II and III were commissioned in 1973, 1974 and 1975, respectively, and Units IV and V were commissioned in 1980 and 1981, respectively. The generating units have already run for more than 20-25 years since their commissioning.

7. According to the querist, depreciation is charged on straightline basis as per the rates prescribed under the Electricity (Supply) Act, 1948, notified from time to time. In respect of assets the rates in respect of which have not been laid down under the aforesaid Act, depreciation is provided on straightline basis at the rates corresponding

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 21 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.

to the rates laid down under the Income-tax Act, 1961. 'X' is providing depreciation on fixed assets from the year following that in which the assets become available for use. The current rate of depreciation on plant and machinery is 7.84% as per the Electricity (Supply) Act, 1948. Further, where the cost of depreciable assets has undergone a change during the year due to increase/decrease in long term liabilities on account of exchange fluctuations, price adjustment, change in duties or similar other factors, the unamortised balance of such assets is depreciated prospectively over the residual life determined on the basis of the rate of depreciation. The expenditure on modification, replacement of the existing plant/equipment under renovation and modernisation scheme and construction/evacuation of Ash Dyke has been treated as deferred revenue expenditure to be amortised over a period of five years from the year of completion of the related package/system.

8. The querist has stated that as per the Electricity (Supply) Act, 1948, an asset has to be depreciated upto 90% of its cost. The plant and machinery of 'X' has already been depreciated upto 90% and, accordingly, though the units are in operation, no depreciation is being provided in the accounts. The residual life of the plant determined on the basis of applicable depreciation rate as per the accounting policy followed is 'nil'.

9. Accounting Standard (AS) 2, 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India, is mandatory in nature in respect of accounting periods commencing on or after 01.04.1999. As per AS 2, machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular should be accounted for in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India. As per AS 10, it may be appropriate to allocate the total cost of such machinery spares on a systematic basis over a period not exceeding the useful life of the principal item.

10. The querist has stated that during the year 2000-2001, a committee was constituted to identify the machinery spares which can be used only in connection with item of fixed asset and are of irregular use. The machinery spares lying in inventory as on 01.04.1999 were identified to be of the value of Rs. 3.90 crore and procurement of machinery spares during the years 1999-2000 and 2000-2001 was Rs. 0.21 crore and Rs. 0.19 crore respectively. Out of the

machinery spares lying in inventory as on 01.04.1999, machinery spares amounting to Rs. 0.20 crore were charged to revenue during the financial year 1999-2000.

11. The management is of the view that since the residual useful life of the asset in the books of account is nil, the cost of machinery spares lying in the inventory as on 01.04.1999 should have been allocated in the financial year 1999-2000 and cost of machinery spares procured thereafter should have been allocated in the respective years of procurement.

12. The querist has stated that during the audit of accounts for the years 2000-2001 and 2001-2002, the auditors were of the view that since AS 10 is silent in respect of allocation of the cost of machinery spares where the principal item of plant and machinery has no residual useful life, the machinery spares should be kept in the inventory. Consequently, during the years 2000-2001 and 2001-2002, machinery spares were kept in inventory and no allocation was made in the accounts and a note was given in the accounts for the years 2000-2001 and 2001-2002 as under:

"As no residual useful life of the principal generating units at 'X', since when commissioned, based on the principle of providing Annual Depreciation, has been left, the capitalisation of machinery spares, in line with AS 10 on 'Accounting for Fixed Assets' and AS 2 on 'Valuation of Inventories', has not been done for want of clarification on its applicability in this particular situation. The issue will be referred to the Institute of Chartered Accountants of India and necessary adjustment, if any, shall be carried out on receipt of the clarification."

B. Query

13. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

- Whether AS 10 is mandatory for generating station 'X' which is owned by Government of India (Ministry of Power).
- If the answer to the above is in the affirmative, how the cost of machinery spares should be allocated in case the principal item of fixed asset has been fully depreciated in the books of account.

C. Points considered by the Committee

14. The Committee restricts itself to the particular issues

raised in paragraph 13 above, i.e., primarily, the accounting treatment of machinery spares where the principal item of fixed asset has been fully depreciated, and has not examined propriety of other related matters like, appropriateness or not of the determination of the useful life of the assets, providing depreciation at the rates corresponding to the rates laid down under the Income-tax Act, 1961, in case where no rates have been specified in the Electricity (Supply) Act, 1948, etc.

15. The Committee notes that the querist has stated in the facts of the case that the annual accounts of 'X' have to be audited by a chartered accountant on an annual basis. In the context of compliance with the Accounting Standards, paragraph 6.1 of 'Preface to the Statements of Accounting Standards' states that, "While discharging their attest functions, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the Standards, it will be also their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations." The Committee also notes the clarification issued by the Council of the Institute titled 'Accounting Standards 1, 7, 8, 9 and 10 Made Mandatory' published in July 1990 issue of the Institute's Journal, 'The Chartered Accountant', paragraph 5 and paragraph 6 of which state as follows:

"5...Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

- (a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations; and ..."

"6. Once an Accounting Standard becomes mandatory, the duties of an auditor with respect to such Standard are the same as those specified at paragraph 5(a) above."

The Committee notes that the Accounting Standard (AS) 10, 'Accounting for Fixed Assets', is mandatory for all enterprises in respect of accounting periods commencing on or after 1.4.1993.

16. From the above, the Committee is of the view that the

auditors of the generating station will have to ensure that AS 10 is complied with in the presentation of financial statements. In the event of any deviation from AS 10, it will be their duty to make adequate disclosures in their report so that the users of such statements may be aware of such deviations.

17. The Committee also notes paragraph 8.2 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which states as follows:

"8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item."

The Committee notes that the Standard requires that the cost of machinery spares of capital nature should be amortised on a systematic basis over a period not exceeding the useful life of the principal item. The querist has stated that the concerned principal items of fixed assets have been fully depreciated in the books of account, i.e., their useful life has already expired. In other words, the assets have no remaining useful life and, hence, the Committee is of the view that the machinery spares of capital nature that can be used only in connection with such type of items of fixed assets, should be charged to the statement of profit and loss in the year of purchase itself. On the same consideration the cost of such machinery spares lying in inventory should be charged to the statement of profit and loss and a disclosure in the notes to accounts should be made in this regard.

D. Opinion

18. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 13:

- (a) The auditors of the generating station 'X' will have to ensure that AS 10 is complied with in the presentation of financial statements.
- (b) The cost of machinery spares should be charged to the statement of profit and loss in the year of purchase itself in case the principal item of fixed asset has been fully depreciated in the books of account. The cost of such machinery spares lying in inventory should also be charged to the statement of profit and loss and a disclosure in the notes to accounts should be made in this regard.