Accounting treatment of income and expenditure incurred during development of ore body of the existing mine

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 government company within the meaning of section 617 of the Companies Act, 1956, and under the administrative control of Department of Atomic Energy, was incorporated in the year 1967. The company is engaged in the operation of mining of ore and processing of the same to produce the final products, which in turn are transferred to the Government of India at administered prices.

2. The company has engaged an outside contractor for developing the ore body of the existing mine so that the present level of production can be maintained. During the process of development, some ore has come out which is around 1% to 2% of annual production of the ore. The value of the final output produced out of such ore, i.e., development ore, has been treated as revenue income.

3. On completion of the development work, the same is capitalised and depreciated at the general rate of 4.75% under the straight line method as per point no. 11(e), i.e., Shafts and inclines, of Note 6 of Schedule XIV to the Companies Act, 1956.

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.

4. The government auditors, during the audit of accounts for the financial year 2000-01, have observed that "profit of the company is overstated by Rs. 0.34 crore due to crediting of the profit and loss account by income of Rs. 0.34 crore earned on sale of ore mined during the development of mine instead of setting off the same against the development expenditure of the mine capitalised during the year".

5. The querist is of the view that as there is no market value of the ore produced by the company, the profit calculated by the government auditors is not correct.

B. Query

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

(a) Whether the rate of depreciation charged by the company on the value capitalised for development work is correct; if not, what should be the treatment of such development expenditure.

(b) Whether the observation made by the government auditors is correct; if not, what should be the treatment of ore produced during the development work.

C. Points considered by the Committee

7. The Committee is of the view that whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement should be decided on the basis of the generally accepted accounting principles in this regard. The Committee notes that only that subsequent expenditure

which increases the future benefits from the existing asset beyond its previously assessed standard of performance should be included in the gross book value, e.g., an increase in capacity.

8. The Committee notes from the facts of the case that the company had incurred expenditure for developing the ore body of the existing mine only to maintain the present level of production. The Committee is, accordingly, of the view that since the development expenditure did not result in increase in the future benefits from the existing mine beyond its previously assessed standard of performance, the same should not have been capitalised. The expenditure incurred to develop the ore body of the existing mine should have been charged to the profit and loss account when the same was incurred.

9. From the above, the Committee is also of the view that charge of depreciation on the value capitalised for the development work is not correct.

10. The Committee is of the view that since, as per paragraph 8 above, the expenditure incurred on development was not eligible for capitalisation, the question of adjustment of the income earned by the company by way of sale of ore produced during the development work against the said expenditure does not arise. In the view of the Committee, the income from sale of products produced from the ore mined during the development work, credited by the company to the profit and loss account for the year, is the correct treatment.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 6:

(a) The depreciation provided by the company on the expenditure capitalised for development work is not correct since the expenditure incurred by the company on development work of mine was not of capital nature as explained in paragraph 8 above. The expenditure incurred for the development of mine to maintain its present level of production should have been charged to the profit and loss account for the year.

(b) The treatment of crediting the income from the sale of ore produced during the development work to the profit and loss account is correct and, therefore, the observation made by the government auditors is not correct.