

Query No. 5

Subject: Depreciation on freehold land having mineral reserves and the internal roads constructed in the premises of the company.¹

A. Facts of the Case

1. A State Government enterprise is engaged in mining and marketing of four major minerals, namely, Rock Phosphate, Gypsum, Lignite and Limestone. The company is also engaged in the business of generating and selling of wind energy.

2. The querist has stated that the company was granted a mining lease for excavation of lignite for a period of 20 years and accordingly, the company has purchased/acquired a 1063.35 hectare of freehold land having estimated mineable lignite reserves to the tune of 172.90 lakh MT for a sum of Rs. 18,98,59,223 in Nagaur district of Rajasthan. As per the approved mining plan, the reserve of lignite is to be mined in 20 years. The ownership of the land would, however, remain with the company after excavation of the entire lignite reserves. According to the querist, the mining (freehold land) area is a hilly area and after mining of lignite, there could be deep pits partly filled with overburden. Such land, as per the querist, after complete excavation of the mining of lignite, would not be useful for the purpose of agriculture and also cannot be used for any other purposes. Besides, the water in the area is highly saline which is not useful for drinking and agriculture purposes. Accordingly, the company considers that the land will not be of any use and will not fetch any value after excavation, and accordingly, net realisable value of the land after complete excavation has been assumed at nil.

3. The querist has mentioned that though the lease agreement was signed on 29/06/2002 but the lease period was started from 25/08/2001 and is valid upto 24.08.2021. Further, there is a provision in the mining lease agreement that the period of mining lease can further be extended as per the relevant provisions of the Mineral Concession Rules, 1960.

4. According to the querist, as the mining lease was for a period of 20 years, the company has adopted the accounting policy to write-off the freehold land on the basis of future benefit likely to be accrued and started writing-off the value of land equally @ 1/20th per annum in view of the fact that as the lease is only for 20 years, the benefit shall be accrued only for the lease period of 20 years. This policy has been reflected in the books of account by way of note reproduced below:

¹ Opinion finalised by the Expert Advisory Committee on 03.05.2011.

Accounting Policies & Notes on Accounts (Schedule 'G')

“Cost of freehold mining land is amortised on the basis of future benefit likely to be accrued.”

5. The querist has also mentioned that as per approved mining plan, the entire quantity of lignite was to be mined out within the period of 20 years by excavating the quantity as mentioned in the mining plan but due to some natural hazards beyond the control of the company, the company could not excavate the requisite quantity of lignite as per approved mine plan. The mining was started in the financial year 2003-04 and till 31st March, 2009, the company could excavate 4.42 lakh MT of lignite as against envisaged production of 31.15 lakh MT. The company however, continued to amortise the land @1/20th each year in view of the fact that the mining lease would expire on 24.08.2021 and it is not certain whether the company would be able to get renewal of lease for a further period or not.

6. The Accountant General (AG) auditors while conducting supplementary audit under section 619(4) have commented that the method of writing off freehold land was not commensurate with the declared accounting policy and the matching principle. According to the auditors, as per matching principle, cost and revenue should match in the period in which they occur and as such, the company should have amortised the freehold land on the proportion of lignite mined during the year and total recoverable reserves available at the beginning of the year. The accounting done by the company was not as per matching principle and the accounting policy because the cost of amortising is not in accordance with the benefits accrued. As such, till 31st March, 2009, the freehold mining land should have been amortised to the extent of Rs. 44,03,809 (18,98,59,223 (cost of land)/172.9 (total recoverable reserves in lakh MT)*4.42(total reserves excavated till March 2009 in lakh MT)) as against Rs. 5,34,07,056. Thus, the company has over amortised the land by Rs. 4,90,03,247.

7. The querist has further stated that the company is also having internal roads in the mine area costing Rs. 3,88,21,682 and the same are depreciated as per Schedule XIV to the Companies Act, 1956, i.e., @ 5 % p.a. on the written down value (WDV). AG Auditor was of the view that internal roads in the mine area should have been depreciated on the line of amortisation of land and accordingly, depreciation on internal roads should have been charged at Rs. 9,92,434 on above lines as against total charge of depreciation of Rs. 65,62,544. Thus, the company has overcharged the depreciation by Rs. 55,70,110. According to the auditors, both these items have resulted in understatement of profit by Rs. 1,03,11,183 for the current year and Rs. 4,42,62,174 for earlier years.

8. While replying to the observations of the auditor, the company was of the view that amortising value of land on the basis of lignite actually mined would result in extending the life of the assets beyond the prescribed period of 20 years for which mining lease is available to the

company. Further, as the power to extend the lease period vests with the statutory authorities which may or may not accept the request of the company to grant further extension of the mining lease, amortising the value of the land on the basis of mineral actually mined and the mineral reserves is not justifiable. Further, as per the querist, actual mineable reserve of 172.9 lakh MTs of lignite is an estimated quantity and actual quantity may be different than the estimated quantity when actual mining would be done.

9. The querist has also stated that paragraph 22 of Accounting Standard (AS) 6, 'Depreciation Accounting', states that the useful life of a depreciable asset should be estimated after considering the following factors:

- (i) expected physical wear and tear
- (ii) obsolescence
- (iii) legal or other limits on the use of the asset

Accordingly, as per the querist, when the company is having mining lease legally only for 20 years, the value of the asset can be amortised only over the period of 20 years. Thus, amortising land on the basis of the actual quantity of lignite mined may not be correct because of the following reasons:

- (i) The company is having mining lease of 20 years only.
- (ii) It is not necessary that the company may be able to get extension of mining lease period.
- (iii) The actual reserve of lignite may not be equal to the estimated reserves.

10. The querist has stated that the actual quantity of lignite mined remained lower due to heavy inrush of water in the mines but the contractor has excavated/removed overburden more than the originally estimated stripping ratio. In case the accounting is to be done on the basis of the matching principle, the expenditure incurred on excavation and removal of higher quantity of overburden as well as expenses incurred for dewatering of mines and other expenses should have also not been charged in the accounts. Accordingly, in the opinion of the company, the policy of amortising 1/20th part of the value of the land every year is correct and is in line with the accounting policy of the company.

11. In reference to audit observation of charging of depreciation on the internal roads on the mining area on the basis of lignite actually mined, the company has replied that the depreciation on the roads cannot be charged on the basis of lignite actually mined, as the roads shall have their own life which is not much affected by actual quantity of mineral excavated and transported through these roads. The roads would also get damaged due to weathering change/effect, even if, not a single tonne of lignite is mined and transported through these roads. The statutory auditors have also concurred with the reply of the company.

12. In response to the reply of the company, the AG auditors have stated that paragraph 22 of AS 6 does not hold good as the said AS 6 is not applicable on wasting assets including expenditure on exploration for and extraction of minerals. Further, paragraph 7 of AS 6 states that the useful life of depreciable asset is directly governed by extraction or consumption. The company has referred the mining lease period whereas paragraph 7 of AS 6 states about lease period of related assets. In the extant case, the related asset is a land which is a freehold property. Hence, the management's contention is not correct.

B. Query

13. Since the views of AG auditors are different from the accounting treatment given by the company, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) whether accounting treatment given by the company for amortisation of the land is in order or not. If not, whether the company should charge depreciation on the basis of mineral actually excavated with respect to the estimated reserves of lignite. Further, in case amortisation of the land is to be done on the basis of quantity of lignite excavated, whether the same is to be done retrospectively.
- (ii) whether depreciation on the road constructed on such land should be charged on the same basis as that of the land or as per Schedule XIV to the Companies Act, 1956.

C. Points considered by the Committee

14. The Committee notes that the basic issues raised in the query relate to depreciation policy of freehold land having mineral reserves for which a mining right has been granted to the company for a period of 20 years and of the internal roads constructed on such freehold land. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as accounting for the right granted to the company for extraction of minerals; accounting for payments made, if any in respect of extraction; accounting for costs to be incurred on restoration of land, if any, after the extraction of minerals; accounting for expenditure incurred on extraction, accounting treatment of stripping costs and expenses incurred on dewatering of mines; impairment related issues; compliance with requirements of law, such as, Companies Act, 1956, in respect of the appropriateness of the method of depreciation; etc.

15. The Committee notes the introduction paragraph and the definition of the term 'depreciable assets' as contained in Accounting Standard (AS) 6, 'Depreciation Accounting', notified under the Companies (Accounting Standards) Rules, 2006, as below:

“Introduction

1. This Standard deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:-

...

This standard also does not apply to land unless it has a limited useful life for the enterprise.” (Emphasis supplied by the Committee.)

“3.2 Depreciable assets are assets which

- (i) are expected to be used during more than one accounting period; and**
- (ii) have a limited useful life; and**
- (iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.”**

16. From the above, the Committee notes that a depreciable asset should essentially have a limited useful life. As per the GAAPs prevalent in India, freehold land is considered to have an unlimited life and, therefore, cost thereof is not depreciated. In the extant case, the Committee notes that the querist has stated that after complete extraction of minerals, the land does not have any economic use to the company due to the reasons stated in paragraph 2 above. The Committee is of the view that keeping in view all the existing circumstances of the case, if it is clearly evident that such land can never be put to any other use, such land should be considered to have limited useful life. In that case, the principles of AS 6 would be applicable. In this context, the Committee notes paragraphs 3.3, 7, 8, 20 and 23 of AS 6 which provide as follows:

“3.3 Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.”

- “7. The useful life of a depreciable asset is shorter than its physical life and is:
- (i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
 - (ii) directly governed by extraction or consumption;
 - (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
 - (iv) reduced by obsolescence arising from such factors as:
 - (a) technological changes;
 - (b) improvement in production methods;
 - (c) change in market demand for the product or service output of the asset;
or
 - (d) legal or other restrictions.

8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.”

“20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.”

“23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an

asset, the unamortised depreciable amount should be charged over the revised remaining useful life.”

17. From the above, the Committee is of the view that the rate of depreciation to be applied to a fixed asset would depend on the depreciable amount of the asset and its useful life. With respect to the ‘useful life’, the Committee notes that paragraph 8 of AS 6 states that determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors, including experience with similar types of assets. The Committee also notes from paragraph 3.3 of AS 6 that useful life can be either the expected period over which asset would be used or expected production/no. of units to be obtained from use of the asset. Further, from the above-reproduced paragraph 23 of AS 6, the Committee notes that useful life of a depreciable asset may be reviewed periodically. The Committee is of the view that in this case, since the sole purpose of acquisition of land is to exploit it for extraction of mineral resources and extraction of such minerals is the only economic use of the land for the company, the useful life of the freehold land would be more appropriately governed by the extractable minerals available on the land and extraction thereof. In other words, it would be more appropriate to depreciate the freehold land on the basis of units of minerals extracted, viz., Units of Production method. Accordingly, keeping in view the aforesaid discussion, the Committee is of the view that the cost of acquisition of freehold land, in the extant case, should be depreciated on the basis of the actual quantity of lignite extracted during a period as against the estimated quantity of extractable mineral reserves. The Committee is of the view that at times, the estimated quantity of mineral reserves also undergoes changes due to subsequent developments, such as, information about the probability of finding additional reserves or information confirming the existence of estimated quantity of reserves, etc. Accordingly, the Committee is of the view that the company should periodically review the estimated unextracted quantity of reserves and it should be used prospectively as the basis of calculating the depreciation of the freehold land. The Committee notes that in the extant case since the right to extract mineral reserves is also subject to the term of the mining lease, while calculating/reviewing the depreciation for a period, the remaining lease period and the reasonable certainty for its extension in the future should also be taken into account.

18. As regards the retrospective application of the depreciation rates determined in accordance with the above, the Committee notes that the change in the method of depreciation from straight-line method to Unit of Production would result into more appropriate presentation of financial statements of the company and accordingly, it should be classified and disclosed as ‘change in accounting policy’ in accordance with paragraph 21 of AS 6, which provides as follows:

“21. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.”

Accordingly, the Committee is of the view that the impact of change in the method of depreciation should be calculated retrospectively from the date of the concerned asset coming into use considering the above-reproduced requirements of paragraph 21 of AS 6 and should be discussed in the period in which such change is made.

19. With respect to charging of depreciation on internal roads in the mine area, the Committee notes that in the extant case, the internal roads may include two types of roads – roads that might exist when the freehold land is acquired and those developed, thereafter, by the company to gain access to mineral reserves. The Committee is of the view that the said roads in the mine area have an independent useful life which would not only depend upon the lignite mined but also on other factors, such as, wear and tear due to weathering effect, etc. Accordingly, the application of unit of production method for depreciation of roads does not appear to be appropriate and the same should be depreciated separately based on their useful life.

20. With respect to the ‘useful life’, the Committee also notes paragraph 13 of AS 6 and paragraph 9 of the Guidance Note on Accounting for Depreciation in Companies, issued by the Institute of Chartered Accountants of India, which provide as below:

AS 6

“13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management’s estimate of the useful life of an

asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute."

Guidance Note on Accounting for Depreciation in Companies

"9. The Committee is of the view that in arriving at the rates at which depreciation should be provided the company must consider the true commercial depreciation, i.e., the rate which is adequate to write off the asset over its normal working life. If the rate so arrived at is higher than the rates prescribed under Schedule XIV, then the company should provide depreciation at such higher rate but if the rate so arrived at is lower than the rate prescribed in Schedule XIV, then the company should provide depreciation at the rates prescribed in Schedule XIV, since these represent the minimum rates of depreciation to be provided. Since the determination of commercial life of an asset is a technical matter, the decision of the Board of Directors based on technological evaluation should be accepted by the auditor unless he has reason to believe that such decision results in a charge which does not represent true commercial depreciation. In case a company adopts the higher rates of depreciation as recommended above, the higher depreciation rates/lower lives of the assets must be disclosed as required in Note No. 5 of Schedule XIV to the Companies Act, 1956."

From the above, the Committee is of the view that while determining the rate of depreciation to be provided on roads, true commercial depreciation which is adequate to write off the asset (viz., roads) over its normal working life based on bona fide technological evaluation, should be considered. However, since Schedule XIV to the Companies Act, 1956 specifies the rates in respect of roads, the rate so determined should not be lower than the rates prescribed in Schedule XIV to the Companies Act, 1956, which represent the minimum rates of depreciation. Depreciation rates higher than the rates prescribed under Schedule XIV can be adopted only if such higher rates are justified on the basis of bona fide technological evaluation.

D. Opinion

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

- (i) Considering the facts and circumstances of the case, the accounting treatment given by the company for amortisation of land is not in order. The depreciation on the freehold land should be determined on the basis of minerals actually extracted during a period with respect to the estimated quantity of extractable mineral reserves, as explained in paragraphs 16 and 17 above. The depreciation as per the correct method of depreciation should be provided retrospectively and the effect of the same should be treated and disclosed as a change in accounting policy as discussed in paragraph 18 above.
 - (ii) No, depreciation on the internal road in the mine area should be calculated and charged on the basis of their own useful lives, which should be based on a bona fide technological evaluations, as explained in paragraphs 19 and 20 above.
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