Treatment of Expenditure on Stabilisation of Expanded Plant Declared Commercial.

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

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') engaged in petrochemicals business decided for an expansion project to enhance the production capacity of its mother plant by about 30%. The expansion project was of complex nature requiring integration of its mother plant with various downstream plants. The execution of the project started in the year 2006.

2. The querist has stated that after completion of the major activities of the said project, the existing plant was shut down from October, 2009 to February, 2010 for completing the installation, integration and commissioning of the project/ plant. Although the existing plant which was shut down during this installation period came into operation from February, 2010, the Parallel Chilling Train and the Extended Binary Refrigeration (EBR) Compressor had not been successfully integrated. As a result, the capacity of the mother plant had not been ramped up and the increased feed from mother plant to auxiliary and other downstream plants had not been achieved. In view of this, the expansion project was not declared commissioned in February, 2010. The plant started operation at nearly 95 % of the enhanced capacity (without one heater which was damaged in fire in July, 2009 and was under reconstruction) for about a month following the integration and commissioning of the EBR and the New Chilling Train (NCT) in May, 2010 and based on an internal certification, the management decided to go ahead with the capitalisation of the project at a cost of ₹1290 crore in the books of account in June, 2010.

3. The querist has further stated that soon after such capitalisation, series of issues came into surface like lower than design yield, high energy consumption, high temperature on gasoline fractionators, failure of vendor supplied systems to achieve design operations, etc., and the plant had to undergo frequent shut downs to address the related problems. Details of such shut down alongwith the root cause analysis and its consequences as analysed by the company's technical department have been provided by the querist for the perusal of the Committee.

4. *In view of the frequent problems faced by the company post commissioning of the project, non-achievement of the expanded capacity of the plant and also considering the opinion given by the licensor, the management of the company has prospectively realised that the expansion project which was commissioned and capitalised in June, 2010 has not yet fully stabilised to operate at the enhanced capacity on a consistent basis* (emphasis supplied by the querist).

5. The company has a technical service agreement with the licensor of its mother plant. All the technical problems as mentioned above were referred to the licensor from time to time for their valued opinion for resolution of problems. In all cases, experts from the licensor visited the plant to assess and identify the root cause of the problems. At the request of the company, licensor

has submitted a report providing its views on the issues being faced by the company wherein they have stated that these kinds of problems are not uncommon to any such complex integration process undertaken worldwide like the expansion project undertaken by the company. They have also stated in the report that "… while the typical time (for installation of such project) is between 3 to 6 months, there have been instances where the plant stabilisation time took more than 18 months as a result of construction issues, mal-functions of vendor supplied equipment or materials, failure of vendor supplied systems to achieve design operation and lack of training or human error". To support its views, it has included a case study in the report, based on their experience in another similar type of company, where it has observed a stabilisation period of 486 days before the company could resolve all technical issues and declare commercial production. In the opinion of the licensor, it was a pre-mature declaration of commissioning by the management in June, 2010.

6. The querist has also stated that after various deliberations with the licensor, management of the company believes that the project should be declared successfully commissioned and capitalised on fulfillment of the following criteria recommended by the licensor in its report dated 20.02.2012, unless waived for valid reasons to be recorded in writing and approved by the competent authority:
   - Steady operation of plant for 4 months.
   - Production rate of 85-90% of expanded capacity on a consistent basis for 2 months.
   - 90% Plant Distributed Control System (DCS) controllers are on auto mode.

The querist has stated that the above-mentioned pre-conditions for carrying out the performance guarantee test as prescribed by the licensor were neither attained in June, 2010 when the plant was declared commissioned and fit for commercial production, nor at any point of time thereafter till date. The company expects to complete the above exercise and to have the successful commissioning of the plant by 30th June, 2012 at a full capacity on sustained basis.

7. In the context of the facts of the case as explained above, the management of the company is of the opinion that:

   (i) Till stabilisation and successful commissioning of the plant in compliance of the criteria and parameters recommended by the licensor, the company should consider costs relating to the expansion project so capitalised earlier as capital work in progress.
   (ii) All subsequent expenditure for rectification of the defects, shut down cost, revenues, gain and loss, etc., incurred during the commissioning and stabilisation period of this expansion project should form part of the project cost.
   (iii) Capitalisation of all such costs as mentioned in point (i) and (ii) above in the books in the year of such successful commissioning.

B. Query

8. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee of the Institute on the aforesaid accounting treatment and whether the same is in conformity with the applicable accounting principles and Accounting Standards.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised in the query relate to accounting for expenditure on rectification of defects, shut down costs, revenues, gains and losses, etc., incurred during the stabilisation period of the expansion project after declaration of its commissioning and fitness for commercial production in June, 2010 and determination of the point of time when costs relating to expansion project should be capitalised alongwith the plant. 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 treatment of expenditure incurred for the expansion of an existing plant, calculation of depreciation of plant during shut down period and

thereafter, impairment of plant due to prolonged stabilisation period, etc. The Committee further wishes to point out that to the extent, readiness to commence commercial production depends on technological evaluation of the plant, has not been examined by the Committee.

10. The Committee notes that the issues raised by the querist require determination of point of time when expansion of the existing plant in the extant case can be considered as ready to commence commercial production, i.e., whether at the point of time when the plant although declared commercial is facing stabilisation problems or at point of time when the plant is stabilised. In this context, the Committee notes paragraphs 9.3 and 9.4 of AS 10, which provide as follows:

> "9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production, i.e., production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.
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> 9.4 If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement. …"

From the above, the Committee notes that the expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production, i.e., production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure. The Committee is of the view that the date when the plant is ready to commence commercial production is a question of fact which should be determined on the basis of various factors, such as, technological evaluation of the readiness of the plant and machinery and other facilities, the quality and the quantity of the output produced, etc. The Committee further notes that in this regard, what is relevant, is the date when the plant is ready to commence commercial production and not the date when the plant actually commences commercial production. Commercial production means production in commercially feasible quantities and in a commercially practicable manner. Thus, if an asset is operational and is able to produce the commercially feasible quality and quantity of goods, no further costs can be capitalised even if it is not achieving targeted or 100% production.

11. The Committee notes from the Facts of the Case that the existing plant was expanded and integrated in May, 2010. Thereafter, the expanded plant was operating at 95% of the enhanced capacity for about a month and accordingly, the expansion project was declared commissioned and the capitalisation of the project was materialised in June, 2010. After capitalisation, the plant had to undergo frequent shutdowns due to problems faced in expanded plant. The querist sought the technical opinion of the licensor on stabilisation of plant for which latter suggested certain parameters referred to as 'performance guarantee test runs' for stabilisation of plant. The Committee notes that as per the Standard, stabilisation of commercial production is not a criterion to determine the point of capitalisation rather it is readiness for commercial production that determines it. Accordingly, the Committee is of the view that the activities undertaken for stabilisation of plant cannot be treated as the test run as prescribed in the Standard. The purpose of test run, in the view of the Committee, is to ascertain whether the plant and machinery and other relevant facilities, as installed, give the commercially feasible output in terms of quality and quantity. If, during the test run, the production standards are not met, normally, the production is stopped and necessary alterations/modifications are made in the plant and machinery. It may be necessary to carry out test run(s) further until

the output of commercially feasible quality and quantity is obtained. The Committee notes that in the extant case, plant after expansion was operational at 95% of the enhanced capacity and was able to produce the commercially feasible goods, and, therefore, was ready for commercial production in June, 2010. Accordingly, in the extant case, capitalisation of expenditure on rectification of defects, shut down costs, revenues, gains and loss, etc., incurred after declaration of commissioning of the expansion project in June, 2010 is not appropriate. Therefore, the question of writing back the costs related to the expansion project, capitalised earlier in June, 2010 to 'capital work in progress', as stated by the querist in paragraph 7(i) above, does not arise.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the expenditure related to expansion should be capitalised along with the plant on the date when the plant after expansion was declared to be ready to commence commercial production (i.e., June, 2010, in the extant case), as discussed in paragraph 11 above. Further, capitalisation of expenditure on rectification of defects, shut down costs, revenues, gains and losses, etc., incurred after declaration of commissioning of the expansion project in June, 2010 is not appropriate. Accordingly, the question of writing back the costs related to the expansion project, capitalised earlier in June, 2010 to 'capital work in progress' does not arise.

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 Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on 31.7.2012. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty volumes. A CD of Compendium of Opinions containing thirty volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
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