

# Accounting for Expenditure on Shared Infrastructure Facilities and Depreciation Thereon

*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 was incorporated under the Companies Act, 1956 during the year 1984-85 and is engaged in construction and operation of thermal power plant in the State of Odisha. The company had set up two power plants of 2 x 210 MW (Units I and II, *i.e.*, Stage 1) as its maiden venture in the district of Jharsuguda known as IB Thermal Power Station and the Units were commercially operated during December, 1994 and June, 1996, respectively. The company is setting up two new power plants of 2 x 660 MW (Units III and IV, *i.e.*, Stage 2) at same location of IB Thermal Power Station, Jharsuguda. During the year 1999, as a part of power sector reforms, the Government of Odisha disinvested 49% of the shares in favour of XYZ Corporation, USA the strategic investor. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956 as amended from time to time.
2. The querist has stated that power generated from Units I and II is sold to ABC Ltd., a Government of Odisha Undertaking, at a tariff determined as per bulk Power Purchase Agreement (PPA) executed during the year 1996. For determination of tariff, the capital cost has been taken as ₹1060 crore in place of total expenditure around ₹1135 crore. Depreciation @ 7.5% per annum of the cost of assets of ₹1060 crore upto 90% of total cost of such asset has been recovered in the tariff by March, 2008 as per the PPA. As per the querist, at present, there is no depreciation available for charging in the tariff as 90% of cost of asset has already been recovered. However, the company has reassessed the useful life of assets following Accounting Standard (AS) 6, 'Depreciation Accounting' and Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and the balance cost of assets including additional capital expenditure is depreciated over the extended useful life as determined and charged to the statement of profit and loss while preparing its financial statements.
3. The querist has further stated that for setting of new power plant Units III and IV (Stage 2), total capital cost has been estimated at around ₹11,500 crore which will be met out of 75% long terms loans and 25% as equity from the investors. 50% of the power generated from Units III and IV shall be sold to ABC Ltd., a Government company engaged in trading of power and balance 50% of power shall be sold to different power purchasers on long-term and short-term basis. As per regulatory norm, the tariff will be determined as per notifications issued from time to time and based upon number of parameters. Total capital cost is taken for determination of equity for calculation of return on equity and loan for determination of interest which is to be taken as fixed cost per unit in tariff. The new project will share some of the existing infrastructure facilities originally constructed for Units I and II (Stage 1) which are under direct control of the company as given below:
  - (a) Township roads and buildings
  - (b) Administrative building
  - (c) Plant roads
  - (d) Coal Handling plant (CHP)
  - (e) Merry-Go-Round (MGR)
  - (f) Intake channel

The above infrastructure facilities as stated at (a) to (f) require substantial capital expenditure for renovation, improvement and addition to make them usable in support of construction of the new project Units III and IV (Stage 2). Without above proposed expenditure, the infrastructure facilities may not support the construction of Stage 2. In other words, the company was not required to spend additional

capital expenditure if there were no proposal for construction of Units III and IV (Stage 2).

*Requirement under Accounting Standard:*

- 4 Accounting Standard (AS) 10, 'Accounting for Fixed Assets,' notified under the Companies (Accounting Standards) Rules, 2006, states as follows:

"12.1 Frequently, it is difficult to determine 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. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

12.2 The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately."

The company is of the view that the above proposed expenditure shall increase the future benefits from the existing asset beyond its previously assessed standard of performance. Again such expenditure is not creating any new asset having separate identity but such asset will be used beyond useful life assessed for power plants at Stage 1.

*Proposed accounting and accounting treatment*

5. The querist has also stated that following the requirement of Accounting Standard as reproduced above, the proposed expenditure shall qualify for capitalisation with original assets, but said capital expenditure shall be incurred and required for construction of Units III and IV (Stage 2). It is essential to book such additional expenses to capital cost of Stage 2 as the same will be taken for determination of tariff for power generated and sold as per power purchase agreement executed/to be executed following regulatory norms. The company has developed accounting codes in respect of different assets separately for booking of such capital expenditure related to Stage 1 and Stage

2 separately, so that actual capital expenditure related to Stage 2 will be determined. The company is of the view that the additional capital expenditure incurred for shared facilities will be booked to respective accounting code of asset under Stage 2 even if it has no separate identity which will be finally consolidated with asset cost of Stage 1 and reported in the financial statements.

6. Following the above proposed accounting, the expenditure incurred for common infrastructure facilities as stated above will be depreciated and segregated for charging to operation Stage 1 (original cost of asset taken for calculation) and Stage 2 (additional cost taken for calculation). Depreciation on additional capital cost for Stage 2 upto the date of commercial operation wherever applicable shall be treated as expenditure during construction for capitalisation and from the date of commercial operation, shall be charged to the statement of profit and loss. The querist has illustrated the treatment with the help of following example:

Example:

Particulars of Assets	Amount in ₹	Remarks
Capital cost of Township Road – Stage 1	100	Already accounted under respective accounting code developed for asset head for Stage 1 and depreciation is charged to the statement of profit and loss.
Additional capital expenditure proposed to be incurred to facilitate construction of Stage 2	150	Proposed to be accounted under respective accounting code developed for asset head for Stage 2 and depreciation upto date of commercial production will be treated as expenditure during construction for capitalisation and after commercial production will be charged to the statement of profit and loss.

Particulars of Assets	Amount in ₹	Remarks
Total Cost	250	Will appear under asset head for reporting under fixed assets in the financial statements. (Notes to balance sheet)

### B. Query

7. In view of the above facts and accounting requirements, the querist has sought the opinion of the Expert Advisory Committee as to whether the proposed accounting method of additional expenditure incurred for shared infrastructure facilities and calculation of depreciation separately for charging to operation for Stage 1 and expenditure during construction for capitalisation for Stage 2 as well as inclusion in the capital cost of Stage 2 is in consonance with the generally accepted accounting principles and Accounting Standards followed in India.

### C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to accounting for additional expenditure incurred on renovation, improvement and addition to existing infrastructure facilities as mentioned in paragraph 3 above that will support the construction activity of Stage 2, depreciation thereon and inclusion of the same in the capital cost of Stage 2. 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, depreciation on the assets other than infrastructural facilities capitalised under Stage 1 and reassessment of the useful life of such assets, calculation of return on equity, capitalisation of asset other than infrastructure facilities being constructed under Stage 2, etc. Further, the Committee wishes to point out that the opinion expressed hereinafter is purely from accounting point of view and not from the angle of regulatory norms for determination of tariff as the accounting considerations may be different from the considerations for determination of tariff.

9. As far as accounting for expenditure incurred on renovation, improvement and addition to

existing infrastructure facilities is concerned, the Committee notes that paragraph 23 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets,' notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') states as below:

***"23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance."***

10. The Committee is of the view that expenditure on fixed assets subsequent to their installation may be categorised into (i) repairs, and (ii) improvements or betterments. Repairs, the Committee notes, implies "the restoration of a capital asset to its full productive capacity after damage, accident, or prolonged use, without increase in the previously estimated service life or capacity." It frequently involves replacement of parts. On the other hand, betterment is defined as "...an expenditure having the effect of extending the useful life of an existing fixed asset, increasing its normal rate of output, lowering its operating cost, or otherwise adding to the worth of benefits it can yield. The cost of adopting a fixed asset to a new use is not ordinarily capitalised unless at least one of these tests is met. A betterment is distinguished from an item of repair or maintenance in that the latter has the effect of keeping the asset in its customary state of operating efficiency without the expectation of added future benefits." (These definitions are reproduced from the Dictionary for Accountants by Eric C. Kohler, Sixth Edition.)

11. From the above, the Committee is of the view that, normally, expenditure on repairs, including replacement cost necessary to maintain the previously estimated standard of performance, is expensed in the same period. Similarly, the cost of adopting a fixed asset to a new use or modernisation/renovation of such asset without actually improving the previously estimated standard of performance is also expensed. Accordingly, in the view of the Committee, only such expenditures that add new fixed asset units, or that have the effect of improving the previously assessed standard of performance, e.g., an

extension in the asset's useful life, an increase in its capacity, or a substantial improvement in the quality of output or a reduction in previously assessed operating costs are capitalised. The Committee is of the view that 'previously assessed standard of performance' is not the actual performance of the asset at the time of repair/improvement *etc.*, but the standard performance of the same asset in its original state.

12. The Committee notes from the Facts of the Case that the capital expenditure is being incurred on existing infrastructure facilities which will support the construction as well as operation of Units III and IV of Stage 2. Further, as per the facts given in paragraph 4 above, the expenditure shall increase the future benefits from the existing asset beyond its previously assessed standard of performance and such asset will be used beyond original useful life assessed for power plants at Stage 1. Accordingly, the Committee is of the view that the additional expenditure incurred on common infrastructure facilities during Stage 2 can be capitalised.
13. With regard to whether additional expenditure can be capitalised under a separate accounting code under the respective asset head for the purpose of charging depreciation thereon separately, the Committee notes paragraph 12.2 of AS 10, notified under the 'Rules', which is reproduced below:

"12.2 The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately."

The Committee also notes paragraphs 9, 23 and 24 of AS 6 as reproduced below:

"9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition

or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life."

***"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.***

***24. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life."***

From the above, the Committee is of the view that it is only an addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is accounted for and depreciated independently on the basis of an estimate of its own useful life. However, in the extant case, the Committee notes from the Facts of the Case (paragraph 4 above) that such expenditure is not creating any new asset which is separately identifiable but such asset will be used beyond useful life assessed for power plants at Stage 1. Accordingly, the Committee is of the view that it should be capitalised with the cost of the existing assets concerned. Further, in case such expenditure results into increase in the *useful life* of the concerned asset, the unamortised depreciable amount of the concerned assets alongwith the expenditure incurred should be charged over the revised remaining useful life subject to the useful life implicit from the rates specified in Schedule XIV to the Companies

Act, 1956. The Committee wishes to point out that such depreciation should be charged with reference to the 'useful life' and not with reference to 'physical life' of the asset. The Committee is also of the view that had such expenditure on infrastructure facility resulted into replacement of existing infrastructure facilities, then such expenditure would have been capitalised while de-recognising the carrying amount of the assets that have been replaced. Further, the costs, thus capitalised would have been depreciated over the useful life of replaced asset subject to useful life implicit from the rate specified in Schedule XIV to the Companies Act, 1956.

14. As regards inclusion of the depreciation charged on the assets used in the construction activity of Stage 2 in the cost of the asset(s) capitalised under Stage 2, the Committee is of the view that to the extent the asset is being used for construction activity, depreciation on the asset is a directly attributable cost of bringing the asset to its working condition for its intended use and accordingly, as per paragraph 9.1 of AS 10, notified under the 'Rules', it should be capitalised with the cost of the asset(s) being constructed following the principles of AS 10. However, the Committee wishes to clarify that the directly attributable cost can be capitalised if the same has been incurred for bringing the asset to its working condition for its intended use. Thus, the depreciation should be capitalised only to the extent to which an asset is actually used for construction activity and any further depreciation incurred after the date of commercial production of the asset(s) being constructed should be charged to the statement of profit and loss.

#### D. Opinion

15. On the basis of the above, the Committee is of the opinion on the issues raised in paragraph 7 above that the proposed accounting treatment of expenditure incurred on infrastructure facilities and calculation of depreciation separately for charging to operation for Stage 1 and expenditure during construction for capitalisation for Stage 2 as well as inclusion in the capital cost of Stage 2 is not in consonance

with generally accepted accounting principles and Accounting Standards followed in India, as discussed in paragraphs 12, 13 and 14 above. The company can capitalise the additional expenditure on common infrastructure facilities during Stage 2 as it shall increase the future benefits from the existing asset beyond its previously assessed standard of performance. However, since such expenditure is not creating any new asset which is separately identifiable, it should be capitalised with the cost of the existing asset concerned. Further, in case such expenditure results into increase in the useful life of the concerned asset, the unamortised depreciable amount of the concerned asset alongwith the expenditure incurred should be charged over the revised remaining useful life subject to useful life implicit from the rates specified in 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 Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on 3 <sup>rd</sup> September, 2013. 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 two volumes. A CD of Compendium of Opinions containing thirty two 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'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to <a href="mailto:eac@icai.in">eac@icai.in</a>