Depreciation for Separate Unit of Refinery on The Basis of an Estimate of Its own Useful Life

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 Government of India undertaking (hereinafter referred to as 'the company') is engaged in refining of crude oil having a refining capacity of 3.0 MMTPA. The company is jointly owned by A Ltd., B Ltd and Government of Assam (GOA). A Ltd. holds 61.65% shares whereas B Ltd. and GOA own 26% and 12.35% respectively. The refinery is located in Golaghat district of Assam and is the fourth refinery in the state of Assam.
2. The refinery was commissioned in the year 2000, i.e., commercial production commenced from 01.10.2000. The refinery consists of various units, such as, the Crude Distillation Unit, Vacuum Distillation Unit, Delayed Coking Unit, Hydro cracker Unit, Hydrogen Generation Unit, Coke Calcinations Unit, Sulphur Recovery Unit. Initially, the refinery was producing high speed diesel (HSD), aviation turbine fuel (ATF), superior kerosene oil (SKO), liquefied petroleum gas (LPG), naphtha, sulfur, raw petroleum coke (RPC) and calcined petroleum coke (CPC). Subsequently, an additional facility for production of motor spirit (MS) was installed in the refinery in the year 2006-07. In the financial year (F.Y.) 2014-15, the refinery also commissioned a Wax Plant Unit as an additional facility which allows the company to produce paraffin wax.
3. The querist has stated that Schedule II to the Companies Act, 2013 has brought in changes in respect of calculation of depreciation based on determination of useful lives of the assets and componentisation of assets. The Schedule prescribes the useful life of different categories of assets as a whole (unlike the depreciation rates prescribed in Schedule XIV to the Companies Act, 1956) and states that where cost of a part of the asset is significant to the total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately. According to the querist, to meet the requirement of new Companies Act, 2013, the company has adopted Schedule II for calculation of depreciation based on estimated useful life for all the assets of company. Accordingly, written down value of existing assets as on 01.04.2014 are being depreciated over the remaining useful life of the assets as prescribed in Schedule II after retaining 5% of the book value. Being a refinery, useful life of the process units are being considered as 25 years as prescribed by Schedule II to the Companies Act, 2013. Accordingly, useful life of the existing plant and machinery assets has been considered as 25 years from the date of capitalisation. During the year 2014-15, the refinery also commissioned its Wax Plant as an additional facility and considered useful life as 25 years from the date of capitalisation for this unit.
4. While conducting the audit of annual accounts for 2014-15, the Comptroller and Auditor General (CAG)auditors have raised the queries against the treatment as below:

   Query 1:

   The tangible assets of the company include an amount of ₹24.75 crore towards plant & machinery for Diesel Quality Upgradation Plan (DQUP) and others. DQUP, a part of Hydrocracker Unit, was capitalised during 2009-10. The useful life of the above assets of DQUP was considered 25 years and their useful life will expire in 2034-35 considering the capitalisation in 2009-10 as per Companies Act, 2013. However, the date of commercial operation of Hydrocracker Unit, i.e., the main unit and also refinery was 01.10.2000 and its useful life will expire on 01.10.2025. As per Companies Act, 2013, written down value of existing assets as on 01.04.2014 should have been depreciated over the remaining useful life of the assets after retaining 5% of the book value.

   Audit was under observation that the additional plant and machinery for upgradation of the Hydrocracker unit should have same useful life as that of Hydrocracker unit and therefore, should have been depreciated by 01.10.2025 after retaining 5% of the book value and not to be depreciated after the life of the main asset i.e. by 2034-35. Therefore, the current useful life considered by the company has resulted in understatement of depreciation and amortisation expenses with corresponding overstatement of profit as well as tangible asset.

Query 2:

Similarly on the same line of argument, the query was raised on the useful life considered for the plant & machinery for wax plant which was capitalised during 2014-15 for an amount of Rs. 327.31 crore with useful life of 25 years (as per Companies Act, 2013) which will expire on 2039-40, which was later to the date of expiry of the useful life of the refinery which is 01.10.2025. Audit observed that the wax plant is the part of the refinery and therefore, the plant and machinery of such unit should have same useful life as that of the refinery. Hence, these assets should have been depreciated by 01.10.2025 after retaining 5% of the book value. Accordingly, useful life considered by the company has resulted in understatement of depreciation and amortisation expenses with corresponding overstatement of profit as well as tangible assets.

5. *Reply given by the company's management:*

To the above mentioned query raised by Government auditors, the company has given its views as under:

Reply to Query 1:

The Schedule II of the Companies Act, 2013 has brought in changes in respect of calculation of deprecation based on determination of useful lives of the assets and componentisation of assets. The Schedule prescribes the useful life of the different categories of assets as a whole and states that where cost of a part of the asset is significant to the total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.

Corporate Laws and Corporate Governance Committee of the Institute of Chartered Accountants of India (ICAI) has also issued an Application Guide on the Provisions of Schedule II to the Companies Act, 2013. A company now needs to identify material/ significant components of an asset separately for depreciation. A component of an asset may have a different useful life which can be higher/lower than the useful life of the main asset. If the component has a lower useful life the same is to be considered for the purpose of depreciation, *but if the component has a higher useful life, the company has the choice to using either higher or lower useful life. Higher useful life is used only when management intends to use the component even after the expiry of the main asset.*(Emphasis supplied by the querist.)

Accordingly, asset additions during DQUP to the Hydrocracker unit are separate components which have a useful life longer than the main asset. Even though the life of the main asset would expire in 2025, the main asset is still expected to operate and generate revenues (as asset renewal is a continuous process) and accordingly these new additions to the Hydrocracker unit have been taken to have a life upto 2034-35. Therefore, the useful life of this component has been considered as that which has been prescribed in Schedule II, i.e., 25 years. Further, in case the original asset becomes redundant and needs to be replaced, the additions during DQUP to the Hydrocracker unit can be used in the new unit also.

Reply to Query 2:

In line with explanation given for Query 1 above, a company needs to identify material/ significant components of an asset separately for depreciation. A component of an asset may have a different useful life which can be higher/lower than the useful life of the main asset. If the component has a lower useful life the same is to be considered for the purpose of depreciation, *but if the component has a higher useful life, the company has the choice to using either higher or lower useful life. Higher useful life is used only when management intends to use the component even after the expiry of the main asset.*

The company has commissioned Wax Plant Unit as an additional facility to the refinery in F.Y. 2014-15. Wax Plant is a separate processing unit and Schedule II of the Companies Act, 2013 has given the useful life for refinery/processing plant and facilities as 25 years. Further if required, Wax Plant can operate independently of the refinery. Accordingly, useful life of the Wax Processing Unit has been considered as 25 years.

B. Query

6. On the basis of above facts, the company seeks the opinion of the Expert Advisory Committee on the following issues:
   (a) Whether the company should consider useful life of the plant and machinery for Diesel Quality Upgradation Plan (DQUP) which was added to the Hydrocracker unit amounting to ₹24.75 crore during F.Y. 2009-10 as 25 years from 2009-10 or as 25 years from the date of initial capitalisation, i.e., 01.10.2000.
   (b) Whether the company should consider useful life for the plant and machinery of the additional facility added to the refinery in the form of Wax Plant which was capitalised during 2014-15 for an amount of ₹327.31 crore as 25 years from the year of commissioning of the Wax Plant or as 25 years from the initial year of the refinery commissioning, i.e., 01.10.2000.
   (c) Going forward, in case additional facilities are added to the refinery and the useful life of the refinery as per Schedule II of 25 years is over, what need to be considered as the useful life for any such new additions?

C. Points considered by the Committee

7. The Committee notes that the basic issues raised in the query relate to the determination of useful life of additional facility, i.e., Wax Plant/Processing Unit added to the refinery and assets under Diesel Quality Upgradation Plan (DQUP) added to Hydrocracker Unit of the refinery for the purposes of providing depreciation on these additional facility/assets. In other words, whether the useful lives of the Wax Plant Unit/assets under DQUP should be considered as same as the useful life of refinery/Hydrocracker Unit or these should be determined independently considering their own useful lives. 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, whether the rate of depreciation or useful life used for determining depreciation for refinery/units is appropriate, etc. Further, the Committee wishes to point out that since the query refers to the financial year 2014-15, the opinion expressed hereinafter is from the perspective of accounting requirements contained in the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and without considering the application of Accounting Standards amended by the Ministry of Corporate Affairs (MCA) vide Notification dated March 30, 2016, which should be applied for the accounting periods commencing on or after the date of such Notification.

8. At the outset, the Committee notes from the Facts of the Case that the querist has referred to the requirements of Application Guide on the Provisions of Schedule II to the Companies Act, 2013 in the context of component accounting. In this regard, the Committee wishes to point out that subsequent to the issuance of the Application Guide on the Provisions of Schedule II to the Companies Act, 2013, the Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013 was issued by the Institute of Chartered Accountants of India (ICAI) in the year 2016, which is applicable for accounting periods commencing on or after April 1, 2016 and its earlier application is encouraged. Accordingly, from the date of the Guidance Note becoming applicable, the requirements contained in the Application Guide to the extent covered by the Guidance Note shall be dealt with in accordance with the requirements of the Guidance Note.

9. In the context of Wax Plant Unit, the Committee notes that in the extant case, the company is treating the refinery as a single unit of measurement of a fixed asset and the various processing units of the refinery as its components. In this regard, the Committee is of the view that in the context of the accounting standards, a component is an integral part of a machine or equipment, without which it cannot function/operate. However, in the extant case, the refinery was operating even without the Wax Plant Unit and the Wax Plant Unit also appears to be capable of operation independently. Therefore, the Committee is of the view that this addition/extension should not be considered as component in the context the same is used as explained above.

Accordingly, the requirements of 'component accounting' as referred to by the querist are not applicable in the extant case and, therefore, the Committee has not examined the issue in the context of Wax Plant Unit. In this context, the Committee notes paragraph 12.2 of Accounting Standard(AS) 10, Accounting for Fixed Assets and paragraphs 9 and 24 of Accounting Standard (AS) 6, 'Depreciation Accounting', notified under the Companies (Accounting Standards) Rules, 2006 which provide as follows:

> *AS 10*
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> "12.2 The cost of an addition or extension to an existing asset which is of 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."
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> *AS 6*
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> 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.
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> ***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 since in the extant case, the Wax Plant Unit has a separate identity and since it has been specifically stated in the Facts of the Case that it can operate independent to the refinery, it is capable of being used after the existing asset is disposed of. Accordingly, Wax Plant Unit should be accounted for as a separate fixed asset and depreciated independently considering its own useful life rather than the useful life of the existing asset, viz., refinery.

10. In the context of determination of useful life of the assets added to the Hydrocracker Unit under Diesel Quality Upgradation Plan (DQUP), the Committee notes from the Facts of the Case that these asset additions apparently result in the upgradation of the Hydrocracker Unit, which should be considered as components of the Hydrocracker Unit considering the Unit as the main asset. Accordingly, considering the requirements of above-reproduced paragraphs 9 and 24 of AS 6, the Committee is of the view that the assets added under DQUP to the Hydrocracker Unit should be depreciated over the remaining useful life of the Hydrocracker Unit/Refinery. In this context, the Committee further notes the requirements of 'component accounting' as per Note 4 of Schedule II to the Companies Act, 2013, which are voluntarily/mandatorily required to be followed by the company in respect of the financial years commencing on or after April 1, 2014/April 1, 2015, respectively, as follows:

> "Useful life specified in Part C of the Schedule is for whole of the asset and where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately."

On the basis of the above, the Committee is of the view that under 'component accounting' approach, where useful life of a component is different from that of the remaining asset, useful life of that component is determined separately from the useful life of the remaining asset and it is depreciated over its own useful life rather than the useful life of the remaining asset. The Committee further notes that as per the requirements of Accounting Standard (AS) 6, 'Depreciation Accounting', 'useful life' represents the period over which a depreciable asset is expected to be used by the enterprise.In this context, the Committee notes from the Facts of the Case that the useful life of additions to Hydrocracker Unit has been considered to be longer than that of the Unit/ Refinery merely based on the presumption that these can be used in a new unit once the original asset/unit becomes redundant and that the Unit/ Refinery will also be continued to be operated even after its useful life would be over, i.e.; the useful life is expected to be revised in future in excess of that considered initially. In this context, the Committee is of the view that determination of useful life of component should be based on its expected use in existing asset(s) and not merely on its use in future new units or expected revision in useful life of existing asset(s). Accordingly, the Committee is of the view that in the extant case, useful life of components (assets added under DQUP) should not be considered to be longer than the existing useful life of the existing Unit/Refinery for providing depreciation thereon.

11. In the context of the opinion, the Committee also wishes to point out that the useful lives prescribed under Schedule II to the Companies Act, 2013 are only indicative. In case, the useful life of an asset as estimated by the company, supported by the technical advice, external or internal, differs, i.e., higher or lower from the indicative useful life given under Schedule II, the former should be applied by the company for providing depreciation.

D. Opinion

12. From the above, the Committee is of the following opinion on the issues raised in paragraph 6 above:
    (a) The useful life of the plant and machinery for Diesel Quality Upgradation Plan (DQUP) added to the Hydrocracker Unit during 2009-10 in the extant case should not be considered to be longer than the existing useful life of the existing asset(s), viz., Unit/Refinery, as discussed in paragraph 10 above.
    (b) The useful life of the Wax Plant Unit, the additional facility added to the refinery, capitalised during 2014-15 for an amount of ₹327.31 crore, should be considered independently considering its own useful life rather than the useful life of the existing asset, viz., refinery, as discussed in paragraph 9 above.
    (c) Going forward, in case additional facilities are added to the refinery/units, the guidance given in (a) and (b) above should be followed.

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 September 2, 2016. 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.
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I, V. Sagar hereby declare that the particulars given above are true to the best of my knowledge and belief.

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V. Sagar
Signature of publisher

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