Query No. 12

Subject: Residual Value of Gas Transmission Pipeline under Ind AS framework.[1]

A. Facts of the Case

1. A Company (hereinafter referred to as 'the Company') was incorporated on 16th August 1984 for procuring, transmission, processing and marketing of Natural Gas. The Company has an authorised share capital of Rs. 10,000 crore out of which Rs. 6,575.10 crore is paid-up share capital. The Government of India holds 51.52% equity of the Company at present. The securities of the Company are listed with NSE, BSE and London Stock Exchange.

2. At present, the Company owns over 14500 kms of Natural Gas pipeline and currently transmits about 206 million standard cubic meter (MMSCM) per day of Natural Gas. The Company operates five liquid hydrocarbon processing plants in different parts of the country with an installed capacity of 1.42 million metric tonne (MT) of liquid hydrocarbons (LHC) per annum. The Company has an integrated petrochemical plant for manufacturing polymers. The Company has world's longest pipeline for transmission of liquefied petroleum gas (LPG). The Company has integrated its business activities and operates into the city gas distribution (CGD), exploration of natural gas, wind power and solar power plant and telecom business. The Company has formed subsidiaries/associates/joint venture companies for CGD, petrochemicals, liquefied natural gas (LNG), gas trading, power generation and shale gas.

3. The Company has prepared its accounts as per Indian Accounting Standards (Ind AS) w.e.f. 1st April 2016. In compliance to Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time, the Company has prepared its first Ind AS financial statements for the financial year (F.Y.) 2016-17 with comparative figures for F.Y. 2015-16.

4. The Company has natural gas pipeline and LPG pipeline across the country. The useful life of the said pipeline is considered as 30 years as per the Schedule II of the Companies Act, 2013. The Company's accounting policy for depreciation of Property, Plant and Equipment (PPE) is as under:

> "i. Depreciation on PPE (including enabling assets) is provided in accordance with the manner and useful life as specified in Schedule II of the Companies Act, 2013, on straight line method (SLM) on pro-rata basis (monthly pro-rata for bought out assets), except for the assets as mentioned below where different useful life has been taken on the basis of external / internal technical evaluation:

Particulars	**Years**
Furniture provided for the use of employees	6 years
Electrical Equipments provided for the use of employees	4 years
Mobile Phones provided for the use of employees	2 years

[1] Opinion finalised by the Committee on 19.4.2023 and 20.4.2023.

ii. Cost of the leasehold land is amortised over the lease period except perpetual leases

iii. Depreciation due to price adjustment in the original cost of fixed assets is charged prospectively."

Further, as per Schedule II to the Companies Act, 2013

> "the useful life and the residual value shall not be different from that as indicated in Part C, provided that if such a company uses a useful life or residual value which is different from the useful life or residual value indicated therein, it shall disclose the justification for the same."[2]

> "Ordinarily, the residual value of an asset is often insignificant but it should generally be not more than 5% of the original cost of the asset."[3]

The Company has adopted residual value of an asset as 5% in line with industry practice.

Further, as per the Operation and Maintenance (O&M) Policy of the Company on 'Pipeline Decommissioning, Recommissioning and Abandonment':

> "The decommissioning option to permanently abandon a pipeline section, and leave in-situ or retrieve, shall be made on the basis of a pre-assessment that shall give consideration to the current and future RoU, use and size of pipeline".

The Company is charging depreciation on pipelines over 30 years (which is as per Schedule II to the Companies Act, 2013) after keeping 5% towards residual value (which is as per Schedule II to the Companies Act, 2013 and industry practice).

5. During the F.Y. 2021-22, Comptroller and Auditor General of India (C&AG) has raised observation in regard to consideration of 5% of capital expenditure (CAPEX) as residual value of the pipelines as under:

> **"Standalone Balance Sheet as at 31st March 2022**
>
> **Assets**
>
> **Non-Current Assets**
>
> **Property, Plant & Equipment (Note 2) Rs. 35,736.71 crore**
>
> The above includes an amount of Rs. 1761 crore as 5 per cent residual value of the pipelines. However, the same should have been zero since the cost to sales thereof is higher than its residual value considered in the books of account.
>
> Ind AS 16 stipulates that the residual value and the useful life of an asset shall be reviewed at least at each financial year-end and if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors'.

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[2] Substituted vide Notification No. GSR 627(E), dated 29.8.2014

[3] Omitted vide Notification No. GSR 237(E), dated 31.3.2014

It was noticed that the Company had neither formed any accounting policy with reference to the periodicity of reviewing the residual value and the useful life of assets nor it is reviewing the residual value of the PPE in line with aforesaid Ind AS provision. It was also noticed that the Company replaced one of its line pipes having a carrying value of Rs. 19.67 crores in the books of account by incurring a cost of Rs. 24.37 crores for digging out and disposing the same, for which it ultimately recovered an amount of Rs. 14.61 crores only. This not only represents overstatement of residual value in the books but has also resulted in less charge of depreciation in the earlier years due to the same. Since, the cost of disposal for line pipes was much more than what the entity might obtain from disposing the said asset, the residual value for the same shall be considered zero.

Thus, non-considering the residual value of line pipes as zero had resulted into overstatement of PPE and Profits for the year to the extent of Rs. 1761 crore each and understatement of depreciation to the same extent. Moreover, the accounting policies of the Company were deficient to that extent.

Management/Joint Statutory Auditors replied that the depreciation on PPE (including enabling assets) was provided in accordance with the manner and useful life as specified in Schedule II of the Companies Act, 2013. Further, as per the Company's O&M policy "the decommissioning option to permanently abandon a pipeline section, and leave in-situ or retrieve, shall be made on the basis of a pre-assessment that shall give consideration to the current and future RoU, use and size of pipeline".

Management/ Joint Statutory Auditors' replies could be viewed in light of the fact that the Company has neither framed any accounting policy nor it was reviewing the residual value & useful life of the asset, at each financial year end. Further, the Company was well aware of the fact that the extractability of the pipeline after their useful life from beneath the ground would not be feasible on technical as well as commercial aspects, thus residual value shall be considered as zero instead of the current consideration."

CAG is of the view that generally, the pipelines are not taken out after completion of their useful life and left as it is under the ground. Further, if the pipelines are taken out, the cost to take out the pipelines will be more than the scrap value of the pipeline. Thus, the net residual value is zero or negative. Therefore, the Company should have kept zero as the residual value for the pipeline instead of 5%.

6. To the said Query, the management of the Company has submitted the reply as under:

"It is submitted that, as per the Company's accounting policy No. 1.11 regarding depreciation/ amortization:

"Depreciation on PPE (including enabling assets) is provided in accordance with the manner and useful life as specified in Schedule II of the Companies Act, 2013, on straight line method (SLM) on pro-rata basis (monthly pro-rata for bought out assets)."

As per Schedule II to the Companies Act, 2013:

> "the useful life and the residual value shall not be different from that as indicated in Part C, provided that if such a company uses a useful life or

> residual value which is different from the useful life or residual value indicated therein, it shall disclose the justification for the same."[4]
>
> "Ordinarily, the residual value of an asset is often insignificant but it should generally be not more than 5% of the original cost of the asset"[5]

The Company has adopted residual value of an asset as 5% in line with industry practice.

Further, as per the Company's O&M policy,

> "The decommissioning option to permanently abandon a pipeline section, and leave in-situ or retrieve, shall be made on the basis of a pre-assessment that shall give consideration to the current and future ROU, use and size of pipeline".
>
> It is further submitted that the residual value for the pipeline whose useful life has already been completed but in use is around Rs. 10.00 crore only. It may be noted that while arriving at financial impact of Rs. 1761 crore, Audit has not considered the depreciation already adjusted against the Gross Block to arrive at deemed cost of PPE at the time of transition to Ind AS. (refer Point No.1.1(e) of Note 1A).

Further, by considering residual value as NIL for the pipeline whose useful life is yet to be completed, the same (i.e. residual value) will be depreciated over the remaining useful life of the asset instead of immediately charging off to the statement of profit and loss as per Ind AS 16.

However, the residual value of pipeline will be reviewed based on technical analysis including industry practice and necessary action will be taken along with the necessary disclosure on residual value during F.Y. 2022-23."

It may be noted that the Pipeline Tariff is being fixed by Petroleum Natural Gas Regulatory Board (PNGRB) and the CAPEX, operating expenditure (OPEX) and Terminal value etc. are considered while fixing the Pipeline Tariff. Tariff Regulation does not specifically deal with the value of terminal value to be considered. However, as a practice, the terminal value based on SLM depreciation basis is considered for calculation of tariff with residual value being not less than 5% of the CAPEX. In case the terminal value is reduced from 5% then there would be possibility of increase in tariff.

As per the O&M Policy of the Company, *"The decommissioning option to permanently abandon a pipeline section, and leave in-situ or retrieve, shall be made on the basis of a pre-assessment that shall give consideration to the current and future RoU, use and size of pipeline."*

The Company analyses whether to take out the pipeline or not on case to case basis considering various technical parameters and availability of RoU and other safety factors. Further, in some of the cases in past, due to non-availability of RoU land, the Company replaced the old pipeline (damaged) with the high diameter pipeline in the same route and the extracted pipelines were sold out as scrap. The digging cost was capitalised along with the

[4] *Ibid*
[5] *Ibid*

new pipeline and scrap value of the old pipeline after adjusting carrying value (i.e. residual value) is recognised in profit and loss account as profit/ (loss) on sale of asset.

It is impracticable to say which pipeline will be taken out and which will not. It has to be seen on case to case basis. Further, in one pipeline, some portion might have to be taken out and the rest may be left as it is.

Considering the above, the Company has kept residual value of the pipeline as 5%.

B. Query

7. In view of above, the querist has sought the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) on the following issues:

(i) Whether the Company’s accounting policy to keep residual value at 5% is in order and in line with applicable Ind AS and Companies Act, 2013.

(ii) In case the answer to (i) above is not affirmative,

(a) whether any other percentage of the residual value of the pipeline may be considered.

(b) if so, the manner and form of such disclosure etc.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to whether the Company’s accounting policy to keep residual value of pipelines at 5% is in order and in line with applicable Ind AS and requirements of the Companies Act, 2013. The Committee has, therefore, examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, depreciation policy of the Company in general, appropriateness of taking useful life different from as specified in Schedule II to the Companies Act, 2013 for certain assets such as furniture, electrical equipment and mobile phones provided for the use of employees, amortisation of leasehold land including perpetual leases, appropriateness of charging of depreciation due to price adjustment in the original cost of fixed asset prospectively, accounting or adjustments made to PPE at the time of transition to Ind ASs including determination of deemed cost as per Ind AS 101, ‘First-time Adoption of Indian Accounting Standards’, appropriateness of accounting treatment of digging/extraction cost in case of replacement of pipelines, determination or estimation of useful life, impact of the accounting treatment on determination of pipeline tariff, accounting for regulatory deferral account balances as per the requirements of Ind AS 114, ‘Regulatory Deferral Accounts’, that may arise on account of differences in treatment of certain items of income, expenses, assets and liabilities for the purposes of preparation of financial statements and for tariff fixation etc. Further, the opinion, expressed hereinafter is purely from accounting perspective and not from any other perspective, such as, tariff regulation etc. Further, the Indian Accounting Standards referred to in the Opinion are the Standards notified under the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time to time.

At the outset, the Committee wishes to mention that the Committee has not considered the situation where the Company has included in the cost of pipeline, the estimated cost towards obligation to dismantle, remove the pipeline and restore the items of PPE viz., 'decommissioning, restoration and similar liabilities'. The same will be dealt with as per the requirements of Ind AS 16, 'Property, Plant and Equipment'.

9. In the context of the issue raised, the Committee notes the following definitions and requirements of Ind AS 16, 'Property, Plant and Equipment' and Schedule II to the Companies Act, 2013, as follows:

Ind AS 16

"Cost **is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Indian Accounting Standards, eg Ind AS 102,** ***Share-based Payment.*****"**

"The ***residual value*** **of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life."**

"51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8, ***Accounting Policies, Changes in Accounting Estimates and Errors.***"

"53 The depreciable amount of an asset is determined after deducting its residual value. In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

54 The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount."

"76 In accordance with Ind AS 8 an entity discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For property, plant and equipment, such disclosure may arise from changes in estimates with respect to:

(a) residual values;

(b) …"

Part A of Schedule II to the Companies Act:

"**1**. Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value. …"

"**3**. Without prejudice to the foregoing provisions of paragraph 1,—

(i) The useful life of an asset shall not ordinarily be different from the useful life specified in Part C and the residual value of an asset shall not be more than five percent of the original cost of the asset:

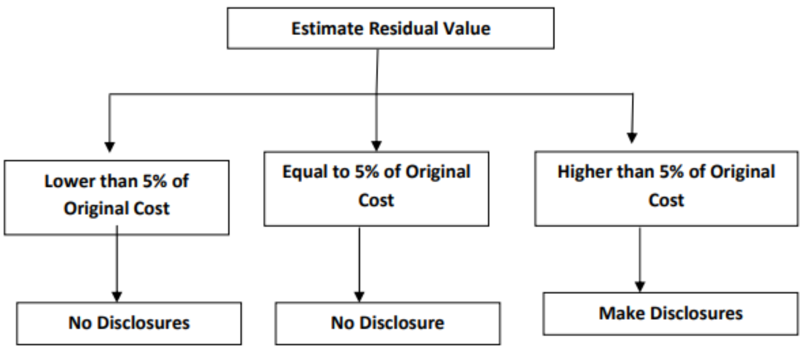
Provided that where a company adopts a useful life different from what is specified in Part C or uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice."

The Committee also notes the following requirements of the Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013 (Issued 2016), issued by the ICAI (hereinafter referred to as 'the Guidance Note') as follows:

"Residual Value of an Asset

15. As mentioned above, paragraph 3(i) of Part A of Schedule II, inter alia, states that the residual value of an asset shall not be more than five percent of the original cost of the asset; provided that where a company uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice. The aforesaid proviso can be taken to mean that the residual value of the asset is indicative in nature. Thus, where the estimate of the residual value of the asset is more than five percent of the original cost of the asset, the company should use that estimate of residual value provided it is supported by technical advice, external or internal, and disclosures in this regard are made as recommended later in this Guidance Note. In case the residual value is estimated to be less than five percent of the original cost of the asset, the same should be used and it would not be necessary to make a disclosure in such a case. The chart given below summarises the position as stated above.

<u>Determination of Residual Value</u>



"

From the above, the Committee notes that residual value is determined for the purpose of determining the depreciable amount of an asset so as to allocate that depreciable amount over the useful life of the asset in a systematic manner. Determination of residual value of PPE is an independent technical process of estimation based on the amount recoverable from disposal of specific asset or the item of PPE after deducting the estimated costs of disposal, *using prices prevailing at the date of the estimate* for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used. The Committee is of the view that the residual value is estimated technically at the beginning of the useful life of the asset and is assessed/reviewed periodically to determine whether there is any change in the original estimate or not. Further, considering the requirements of Schedule II to the Companies Act, 2013, Ind AS 16 and Guidance Note, the Committee is of the view that the Company has to first estimate residual value of an item of PPE/asset as per the requirements of Ind AS 16 and then compare it with 5% of its original cost. Even if, estimated residual value is more than 5% of the original cost of the asset, the Company should use that estimated residual value along with appropriate disclosure and justification as per the requirements of Schedule II. Therefore, the contention of the querist in this regard to keep the residual value of pipelines at standard 5% as per Schedule II requirements is not appropriate. The Committee is of the view that providing depreciation and estimation of useful life as well as residual value is an asset-specific process. The basic purpose of charging depreciation is to allocate depreciable amount of an asset over *its* useful life. For each individual asset(s), the conditions (in which it is operating) during the useful life may be different leading to a different residual value. For example, in the extant case, pipelines operating in different geographical locations may be subject to different working conditions and environment and therefore, the residual value at the end of their useful lives may be different from one another. Therefore, it is not appropriate to consider same residual value for all the pipelines in such case.

10. The Committee further notes that the querist has also stated that it is impracticable to determine that which pipelines will be extracted and which will not. The Committee is of the view that *a reasonable estimate* based on the various factors such as, terms of lease/contract for Right of way or Right to use of land to lay pipelines, location of pipelines, past experience or historical data and future estimate etc. should nevertheless be made by the Company *at the beginning of useful life*, considering the facts and circumstances at that time, which should further be reviewed at each financial year-end, as per requirements of Ind AS 16. Thus, any change in circumstances or situations in future (like change in decision with regard to whether the pipeline will be extracted or not, etc.) shall be considered while determining residual value every year. Therefore, the Committee is of the view that the Company should consider its facts and circumstances at the date of making estimates/review while determining the residual value of its various pipelines. Further, the estimated costs of disposal should also be considered as per the definition of residual value given in Ind AS 16. In case, the pipeline will not be extracted and will just be abandoned, the residual value should be considered 'nil' as nothing can be sold as scrap or otherwise. Further, in case, it is estimated that the pipeline will be extracted and sold, the cost attributable to extraction activity should also be considered/adjusted while determining the residual value.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

(i) The Company's accounting policy to keep a standard residual value of 5% without considering all the facts and circumstances is not appropriate.

(ii) (a&b) The Company should determine the residual value of its various pipelines considering its facts and circumstances at the beginning of their useful life, which should be reviewed at each financial year-end, as discussed in paragraph 10 above. Further, the estimated costs of disposal should also be considered as per the definition of residual value given in Ind AS 16. In case, the pipeline will not be extracted and will just be abandoned, the residual value should be considered 'nil' as nothing can be sold as scrap or otherwise. Further, in case, it is estimated that the pipeline will be extracted and sold, the cost attributable to extraction activity should also be considered/adjusted while determining the residual value.

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