Compendium of Opinions
(Volume XXXV)
of the
Expert Advisory Committee

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
(Set up by an Act of Parliament)
NEW DELHI
Foreword

Financial Reporting is usually considered as an end product of accounting. Financial Reporting provides vital information about the financial health and activities of the company to its stakeholders including its shareholders, potential investors, consumers and government regulators. The Institute of Chartered Accountants of India has issued various pronouncements including accounting standards and guidance notes which are applied for the purpose of financial reporting. With a view to give guidance to the professionals while applying and implementing such accounting principles in specific facts and circumstances, the Council of the Institute of Chartered Accountants of India (ICAI) had constituted the Expert Advisory Committee to reply to the queries on accounting, auditing and allied matters received from the members of the Institute.

Since its inception, the Expert Advisory Committee has been giving independent and objective opinions to the members in industry and practice. The Committee has also been providing opinions on various accounting issues to the Regulatory and Government authorities, such as, Comptroller and Auditor General of India, Ministry of Corporate Affairs, etc.

I compliment CA. Sanjiv Kumar Chaudhary, Chairman, CA. Debashis Mitra, Vice-Chairman and other members of the Expert Advisory Committee who have contributed immensely in the working of the Committee.

I firmly believe that this volume of the Compendium of Opinions would be as useful and beneficial to the members and others interested as the other volumes.

New Delhi
February 7, 2017

CA. M. Devaraja Reddy
President
I am pleased to present to the profession another volume of the Compendium of Opinions, viz., thirty-fifth volume. This volume of the Compendium of Opinions contain opinions that were finalised by the Committee in the Council Year 2015-16 during my tenure as Chairman of the Committee. I consider myself to be fortunate to be continuously associated with the Expert Advisory Committee during my tenure in the Council, either as Chairman, Vice-Chairman or as a member of the Committee since 2013.

This volume contains opinions on diverse subjects, such as, Amortisation of SAP license and accounting for annual renewal fee, Accounting treatment of pre-operative and preliminary expenses incurred on formation and incorporation of the company, Accounting treatment in respect of foreign currency loans hedged by a composite cross currency interest rate swap contract and accounting therefor, Accounting treatment of various kind of budgetary support received from the Government and various types of expenditure incurred by the company, Treatment of royalty paid in dispute pending the final decision of the Court and Determination of the average net profit for the purpose of incurring Corporate Social Responsibility (CSR) expenses and disclosure of CSR expenses in the financial statements, etc.

I may apprise the readers that an opinion given or views expressed by the Expert Advisory Committee constituted by the Council of the Institute, represents the opinion or view of the members of the Committee and not the official opinion of the Council. I would also like to point out that the opinions expressed by the Committee are based on the facts and circumstances of the query as supplied by the querist, considering the relevant laws and statutes, and the applicable accounting/auditing principles prevailing on the date on which the Committee finalises the particular opinion. The date of finalisation of each opinion is indicated along with the respective opinion. The opinions must always be read and applied in the light of any subsequent developments and/or amendments in the applicable legal position and accounting/auditing principles that might affect the opinions.

I would also like to inform the readers that the Expert Advisory Committee
answers the queries only in accordance with the Advisory Service Rules prescribed by the Council of the Institute in this regard. These Rules have also been published at the end of this volume.

This volume, like other recent volumes, also contains a Compact Disk (CD), which is a comprehensive CD incorporating all the opinions published in all the volumes (viz., Volume I to Volume XXXV) of the Compendium of Opinions. The CD of Compendium of Opinions contains advanced and user friendly search facilities to locate the opinions on desired subject(s) and/or the opinions issued during a particular period. I hope that this CD would prove to be of great use and significance for the members.

I also take this opportunity to thank all the members and special invitees of the Expert Advisory Committee during the Council Year 2015-16, namely, CA. Shrinivas Y. Joshi (the then Vice-Chairman), CA. Manoj Fadnis (the then President), CA. M. Devaraja Reddy (the then Vice-President), CA. Rajkumar S. Adukia, CA. Dhinal Ashvinbhai Shah, CA. Nilesh Shivji Vikamsey, CA. Babu Abraham Kallivayalil, CA. K. Raghu, CA. S. Santhanakrishnan, CA. Abhijit Bandyopadhyay, CA. Vijay Garg, CA. Mukesh Singh Kushwah, CA. Sanjiv Agarwal, CA. Naveen N.D. Gupta, Shri Manoj Kumar, Shri A M Bajaj, Shri Bhaskar Chatterjee, CA. Niren Nagri, CA. S. Narasimhan, CA. Archana Bhutani, CA. Jayant Gokhale, CA. Haridas Bhat, CA. Rahul Gupta, CA. Sanjeev K. Maheshwari, CA. J. Venkateswarlu and CA. Vishal Bansal for their efforts in finalisation of opinions contained in this volume. I also take this opportunity to appreciate the sincere efforts and support of my learned colleagues on the Expert Advisory Committee during the current Council Year (2016-17).

I would also like to acknowledge the persistent efforts and support of Dr. Avinash Chander, Technical Advisor and CA. Parul Gupta, Secretary, Expert Advisory Committee in the process of formulating the drafts for the consideration of the Committee and thereafter in finalising them as per the decisions of the Committee.

I am very confident that like all other previous volumes, this volume will also prove to be very useful to the members and others concerned.

New Delhi
February 7, 2017
CA. Sanjiv Kumar Chaudhary
Chairman
Expert Advisory Committee
Contents

Foreword

Preface

1. Accounting treatment of pension liability post-separation. 1
2. Accounting for expenditure incurred as a pre-condition to obtaining environmental clearance for setting up power project and coal mines. 10
3. Amortisation of SAP license and accounting for annual renewal fee. 19
4. Provisioning for doubtful receivables. 29
5. 1. Accounting treatment of pre-operative and preliminary expenses incurred on formation and incorporation of the company. 37
   2. Accounting treatment of finance cost and other pre-operative expenses incurred during pre-operative period.
   3. Accounting for interest earned on fixed deposits made out of idle funds, interest earned on mobilization advance and other miscellaneous income during pre-operative period.
6. Accounting treatment for amalgamation of wholly owned subsidiary. 60
7. Requirement of preparation of complete/condensed set of financial statements for interim financial reporting. 68
8. Method of depreciation as per requirements of the Companies Act, 2013. 74
9. Accounting treatment in respect of foreign currency loans hedged by a composite cross currency interest rate swap contract and accounting therefor. 79
10. Netting off interest income against interest cost in standalone books of parent company.

11. Accounting treatment of deposit of non-refundable upfront premium including processing fee.

12. Accounting treatment of various kind of budgetary support received from the Government and various types of expenditure incurred by the company.


14. Treatment of expenditure incurred by the company on roads for transportation of coal.

15. Accounting treatment for the project assets under construction.

16. Treatment of royalty paid in dispute, pending the final decision of the Court.

17. Application of paragraph 21 of AS 22.

18. Determination of the average net profit for the purpose of incurring Corporate Social Responsibility (CSR) expenses and disclosure of CSR expenses in the financial statements.

Advisory Service Rules
Query No. 1

Subject: Accounting treatment of pension liability post-separation.

A. Facts of the Case

1. A company S (hereinafter referred to as the 'company') is a public limited company listed on National Stock Exchange (NSE) and Bombay Stock Exchange (BSE). In the year 2009, as a part of a business transfer agreement with one of its customers N, S took over 35 employees in Germany. As a part of the business transfer agreement, S agreed to takeover customer's employees under same terms and conditions under which employees were employed immediately prior to the agreement. It was also agreed that obligations of the customer N arising from employment relationships with transferred employees shall pass to S as on the agreement date. Towards this obligation, customer N reimbursed S for an amount as agreed on the agreement date. S will be responsible for all employee related obligations on and after the agreement date. Accordingly, the pension liabilities of the employees of N were taken over by S.

2. The querist has stated that under the German law, pension is a defined benefit plan. For the purpose of pension payments and administration, N had established a fully reinsured support fund which converted defined benefit plan into contribution type defined benefit plan. With transfer of pension liabilities to S, S got admitted to the fully reinsured support fund and took over the accumulated balances of the reinsured support fund of N. The basic principles of the reinsured support fund are detailed by the querist in Annexure I.

3. In the financial year (F.Y.) 2011-12, due to changes in business scenario, the transferred employees were terminated after complying the regulatory requirements in Germany. The pension liabilities continued to be with S as they would be paid out only on death of an employee or he/she reaching retirement age, whichever is earlier. S continues to make contribution which also includes a defined annual insurance premium to the reinsured support fund and keeps the reinsurance in force - the benefits of the insurance have been supplied by the querist in Annexure I. As per the querist, this is supposed to take care of the changes in the interest rates and make the scheme similar to defined contribution scheme by taking away the effect of changes in interest rates.

1Opinion finalised by the Committee on 23.4.2015.
4. The querist has further stated that since the employees are no longer on rolls, the pension amounts and periodic contributions are not subject to any change on account of changes in base salary (as the base salary will be the same as on the date of separation). Further, the pension liability to the employee when it becomes due will be met by the support fund. The company continues to be liable for fulfillment of pension promise, in contingent events, such as, the insurance company goes bankrupt. In the event of underfunding, the employer must pay the part of the benefit due, which cannot be paid by the support fund (because of underfunding), out of its own means. Realistically, since the support fund is fully reinsured, and till such time that a contingent event happens, and as long as the reinsurance is in force, it is unlikely that there will be underfunding. In addition to the pension promise, the company is also liable for pension adjustments to the guaranteed vested amount due to inflation. Traditionally, the inflation rate in Germany has been around 2%. However, the company expects that the increase in the guaranteed return from the contributions made to the fund, will cover the inflation costs and therefore, there is a good chance that the inflation adjustments will be met by surplus in the fund.

B. Query

5. Given this background, the querist has sought the opinion of the Expert Advisory Committee as to whether the scheme can be treated as defined contribution scheme and accordingly, whether it is appropriate for the company to consider the periodic contribution only as its expense for a given period in the financials. Reason for this being that there is a periodical payment to the support fund. This support fund will take care of the interest rate fluctuation and guarantee the payment to ex-employees on retirement or death whichever is earlier. This, as per the querist, will also eliminate the fluctuation in profit and loss account and make more sense to investors.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised in the query relates to whether the pension scheme to the terminated employees in the extant case can be treated as defined contribution scheme and accordingly, whether it is appropriate for the company to consider the periodic contribution only as its expense for a given period in the financial statements. Accordingly, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, accounting in the financial statements (prepared, if any) of support fund and customer
N, accounting for transfer of employees by N, whether the scheme in the extant case can be considered as multi-employer plan, detailed accounting aspects of the scheme, accounting as per the German accounting principles, etc.

7. The Committee notes from the Facts of the Case that the company took over employees of its customer N as a part of business transfer agreement under the same terms and conditions under which employees were employed immediately before the agreement. Further, the obligations of N including pension liabilities arising from employment relationship were transferred to company S. Later on in F.Y. 2011-12, the transferred employees were terminated. However, the pension liability continued to be with the company. In this connection, a question may arise with regard to the nature of pension benefits. Accordingly, the Committee notes the following requirements of Accounting Standard (AS) 15, ‘Employee Benefits’, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the ‘Rules’):

“7.1 Employee benefits are all forms of consideration given by an enterprise in exchange for service rendered by employees.”

“7.3 Post-employment benefits are employee benefits (other than termination benefits) which are payable after the completion of employment.”

“7.9 Termination benefits are employee benefits payable as a result of either:

(a) an enterprise’s decision to terminate an employee’s employment before the normal retirement date; or

(b) an employee’s decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement).”

“133. This Standard deals with termination benefits separately from other employee benefits because the event which gives rise to an obligation is the termination rather than employee service.”

“136. Some employee benefits are payable regardless of the reason for the employee’s departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits may be described
as termination indemnities, or termination gratuities, they are post employment benefits, rather than termination benefits and an enterprise accounts for them as post-employment benefits. Some enterprises provide a lower level of benefit for voluntary termination at the request of the employee (in substance, a post-employment benefit) than for involuntary termination at the request of the enterprise. The additional benefit payable on involuntary termination is a termination benefit.”

The Committee notes from the Facts of the Case that the benefits to the employees are paid not due to their termination rather due to the service rendered by the employees before their termination. Therefore, the Committee is of the view that these cannot be considered as termination benefits and should be considered as post-employment benefits.

8. With regard to the type of post-employment plan, the Committee further notes the following requirements from AS 15:

“7.5 Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

7.6 Defined benefit plans are post-employment benefit plans other than defined contribution plans.”

“24. Post-employment benefits include:

(a) retirement benefits, e.g., gratuity and pension; and

(b) other benefits, e.g., post-employment life insurance and post-employment medical care.

Arrangements whereby an enterprise provides post-employment benefits are post-employment benefit plans. An enterprise applies this Standard to all such arrangements whether or not they involve the establishment of a separate entity to receive contributions and to pay benefits.

25. Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic
substance of the plan as derived from its principal terms and conditions.

Under defined contribution plans:

(a) the enterprise’s obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an enterprise (and also by the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions; and

(b) in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee.

26. Examples of cases where an enterprise’s obligation is not limited to the amount that it agrees to contribute to the fund are when the enterprise has an obligation through:

(a) a plan benefit formula that is not linked solely to the amount of contributions; or

(b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; or

(c) informal practices that give rise to an obligation, for example, an obligation may arise where an enterprise has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

27. Under defined benefit plans:

(a) the enterprise’s obligation is to provide the agreed benefits to current and former employees; and

(b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise. If actuarial or investment experience are worse than expected, the enterprise’s obligation may be increased.”
“40. An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have (either directly, or indirectly through the plan) an obligation to either:

(a) pay the employee benefits directly when they fall due; or

(b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

If the enterprise retains such an obligation, the enterprise should treat the plan as a defined benefit plan.”

“42. Where an enterprise funds a post-employment benefit obligation by contributing to an insurance policy under which the enterprise (either directly, indirectly through the plan, through the mechanism for setting future premiums or through a related party relationship with the insurer) retains an obligation, the payment of the premiums does not amount to a defined contribution arrangement. It follows that the enterprise:

(a) accounts for a qualifying insurance policy as a plan asset (see paragraph 7); and

(b) recognises other insurance policies as reimbursement rights (if the policies satisfy the criteria in paragraph 103).

43. Where an insurance policy is in the name of a specified plan participant or a group of plan participants and the enterprise does not have any obligation to cover any loss on the policy, the enterprise has no obligation to pay benefits to the employees and the insurer has sole responsibility for paying the benefits. The payment of fixed premiums under such contracts is, in substance, the settlement of the employee benefit obligation, rather than an investment to meet the obligation. Consequently, the enterprise no longer has an asset or a liability. Therefore, an enterprise treats such payments as contributions to a defined contribution plan.”

The Committee notes from the Facts of the Case that although the pension liability to the employee when it becomes due will be met by the support
fund, which is fully reinsured, the company continues to be liable for fulfillment of pension promise, in contingent events such as, if the insurance company goes bankrupt and in the event of underfunding. Thus, the employer, viz., the company will have to pay the part of the benefit due, which cannot be paid by the support fund (because of under funding) out of its own means. Further, in addition to the pension promise, the company is also liable for pension adjustments to the guaranteed vested amount due to inflation. Thus, although the company expects that the increase in the guaranteed return from the contributions made to the fund, will cover the inflation costs and the inflation adjustments will be met by surplus in the fund, in case surplus in the fund is not able to meet inflation adjustments, the same will be met by the company. Accordingly, the Committee is of the view that since in case of underfunding with the support fund and in case of contingency of insolvency of insurer, deficit is to be met by the employer (company S), the plan in the extant case is a defined benefit plan and not a defined contribution plan. Therefore, the company cannot treat only the periodic contributions for a period as its expenses in its financial statements.

D. Opinion

9. On the basis of the above, the Committee is of the opinion that the pension scheme in the extant case cannot be treated as defined contribution scheme and accordingly, it is not appropriate to consider the periodic contribution only as its expense for a given period in the financial statements of the company, as discussed in paragraph 8 above.
Annexure I

Reinsured support fund

The graph below illustrates the basic principle of financing occupational pensions or lumpsum benefits by a reinsured support fund:

The basic principle of a contribution-type defined benefit plan financed by a fully reinsured support fund can be briefly described as follows:

- The employer gives a pension promise in line with the support fund’s benefit plan (‘Leistungsplan der Unterstützungskasse’) to the employee.
- The scope of employer contributions is commonly defined in the plan document (e.g., a fixed percentage of the employee’s annual gross base salary in the particular calendar year).
- These defined contributions are paid by the employer to the support fund (‘allocations’).
- The support fund takes out a life insurance (reinsurance) contract on the employee’s life and as the policy-holder, is entitled to the insured benefits.
- The reinsurance premiums payable by the support fund to the life insurer are identical with the amount of employer contributions.
- According to the applicable plan provisions, the employee is
entitled to benefits equal to the benefits insured under the reinsurance policy.

- Thus, defined employer contributions are actuarially converted into guaranteed minimum entitlements to benefits on the basis of a life insurance tariff. Up to the guaranteed interest rate, the insurer and - lower-ranking - the employer (due to the subsidiary liability e.g. in the event of insolvency of the insurer) bear the investment risk.

- In excess of the guaranteed interest rate, the employee bears the investment risk. However, the plan concept also offers good prospects for the employee, as dividends granted by the insurer are entirely used to increase his/her entitlement to benefits.

- After the occurrence of an event giving right to a benefit (e.g., retirement or death), the support fund receives the insured benefit plus dividends from the life insurer and, simultaneously, pays out the benefit due to the beneficiary.

- As a rule, mandatory adjustments of pensions (e.g., pre-retirement disability of the employee) in payment can be financed by the dividends granted by the insurer.

- Due to legal constraints, a support fund is not allowed to grant a legal claim to benefits. This fact, however, does not result in a potential risk or disadvantage for the employee.

- According to the German Company Pension Law, the sponsoring company (i.e., the employer) remains liable for the fulfillment of the pension promise (so called subsidiary liability). Thus, in the (unlikely) event of underfunding (e.g., insolvency), the employer must pay the part of the benefit due which cannot be paid by the support fund (because of underfunding) out of own means.

- According to the German Company Pension Act, the employer is obliged to contribute towards the statutory insolvency protection (‘Pensions-Sicherungs-Verein’) of the Government of Germany, even if the support fund takes out congruent reinsurance. The insolvency protection insurance covers the risk of insolvency of the Government of Germany.
As per German tax and accounting standards, corporates/listed companies in Germany are not required to account for such pension assets and obligations as assets and liabilities in their balance sheet. Instead, a mere disclosure in notes to accounts of any deficits (i.e., pension obligations minus support fund’s assets) is sufficient, given that the support fund has claim to benefits under the re-insurance contract to cover the defined benefit obligations to the employees.

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Query No. 2

Subject: Accounting for expenditure incurred as a pre-condition to obtaining environmental clearance for setting up power project and coal mines.¹

A. Facts of the Case

1. A company incorporated as a wholly owned Government company under the Companies Act, 1956 during the year 1984-85 is engaged in construction and operation of thermal power plants in the State of Odisha. The company had set up two power plants of 2 x 210 MW (Units I and II that is 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. Power generated from units I and II is sold to A Ltd, a Govt. of Odisha Undertaking at a tariff determined as per Bulk Power Purchase Agreement executed during 1996. During 1999, as a part of power sector reforms, the Govt. of Odisha disinvested 49% of the shares in favour of ABC 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 company is setting up two new power plants of 2 x 660 MW (Units III and IV that is Stage - 2) at same location of IB Thermal Power Station,

¹ Opinion finalised by the Committee on 23.4.2015.
Jharsuguda with capital cost estimated around Rs.11,547/- crore which will be met out of 75% long terms loans and 25% as equity from the investors. Besides the above, two coal blocks i.e., Manoharpur (181.68MT) and deepside of Manoharpur II (350MT) were allotted by the Ministry of Coal during the year 2007 at Sundergarh district inside the State of Odisha. The quantity of coal which is to be extracted from the coal mine development by the company will be only utilised in generation of electricity for new power plants (2X660MW), which are under construction.

3. The company has incurred expenses in peripheral villages in the areas of health, education, drinking water, road, street lighting, lift irrigation, culture and sports functions etc. Expenses incurred as above are accounted as follows:

(a) Expenses incurred in periphery villages of the operational units as well as areas where other units and establishments are situated are booked under accounting head ‘Peripheral Development Expenses’ and debited to the statement of profit and loss. (Emphasis supplied by the querist.)

(b) It may be noted that the power project as stated above has been considered in accordance with the provisions of Environmental Impact Assessment (EIA) notification, issued by the Ministry of Environment and Forest vide SO-1533 (E) Sept-2006. Based on information submitted by the company, the Ministry of Environment has accorded environmental clearance of the above project under the provision of EIA notification dated 14th September, 2006 subject to compliance of different conditions as amended by its letter dated 4.2.2010. As per Clause 4(xxvi) of above letter, an amount of Rs. 24.36 crore shall be earmarked as one time capital cost for CSR programme. Similarly, for coal mine project, the Ministry of Environment and Forest, while granting environmental clearance for open cast coal mine project has informed compliance of certain conditions vide its letter dated 21.02.2014. As per clause 2(xx), the CSR cost has been calculated @ Rs. 5/ Te. for 152.12 MT minable resources amounting to Rs. 7606 lakhs. While according approval, the Ministry of Environment and Forest accorded environmental clearance of open cast coal mine project under the provision of EIA notification 2006 and subsequent amendment thereto subject to the compliance of the
terms and conditions as specified in the said letter. As per special conditions contained in clause A (ix), the CSR amount should be Rs. 4 crores in initial 3 years, and thereafter it should be Rs. 5/T of coal /annum till the end of the life of project with the escalation of coal production. In addition to above CSR compliances, it is also required to comply with other conditions like expenses on rehabilitation resettlement and wildlife conservation plan. (Emphasis supplied by the querist.)

4. The querist has stated that keeping in view the mandatory requirement as above and condition to environmental clearance accorded to both power project and coal mines, the treatment made in the accounts is as follows:

Expenses incurred in periphery villages as a requirement and condition to new power plant (2 * 620MW) and coal mines booked under the head ‘Peripheral Development’ and grouped under the ‘Expenditure During Development / Construction of Power Project’ and ‘Expenditure During Development Coal Mines’ which will be capitalized on commissioning of the project / coal mines as the case may be.

(Emphasis supplied by the querist.)

5. Significant accounting policies of the company are as follows:

Development of Power Projects & Coal Mines:

“Expenditure on exploration and development of new coal mines is capitalised as ‘Development of coal mine’ under ‘Capital Works in Progress’ till the Mines Project brought to operation.”

“Expenditure on development of new power projects is capitalized as ‘Development of Power Projects’ under Capital Work in Progress.”

6. The Comptroller and Auditor General of India (C&AG) while conducting supplementary audit under section 619(3) of the Companies Act for the financial years 2012-13 and 2013-14, has raised observations on accounting treatment of peripheral development expenses (CSR expenses). Observations of C&AG and management replies submitted in response to said observation are given as follows:
As per paragraph 9.2 of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.

Peripheral development expenses are incurred specifically attributable to construction of units III & IV and coal mining project and correctly accounted as capital work in progress in compliance to AS 10. In view of above, there is no understatement of prior period expenses (net) (Note-27) by Rs. 35.75 lakh, peripheral development expenses (Note-26) by Rs. 27.96 lakh, overstatement of capital work-in-progress (Note-26) by Rs. 27.96 lakh, overstatement of capital work-in-progress (Note-12) and profit for the year by Rs. 63.71 lakh.

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2 The opinion should be read in the context of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, which has been revised as AS 10, ‘Property, Plant and Equipment’ by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.
7. The company is of the view that peripheral development / CSR expenses as stated above are mandatory and a condition to environment clearances for the project (2 * 660MW power plant and coal mines). Without such clearances, the power project and coal mining project will not come into existence. These expenses are specifically attributable to construction of a project and for bringing the said project into its working condition and satisfy the requirements under AS 10. So accounting treatment made by the company as stated above as part of cost of the construction project (units III & IV) and coal mining project is in consonance with generally accepted accounting principles and Accounting Standards.
B. Query

8. In view of the above facts and accounting requirements, the company seeks the opinion of the Expert Advisory Committee as to whether the accounting treatment made in the accounts for peripheral development expenses (CSR expenses) in respect of power project and coal mines as a condition to environmental clearance by way of ‘Expenditure during Development / Construction of Power Project’ and ‘Expenditure during Development Coal Mines’ which will be capitalised on commissioning of the project / coal mines as the case may be, is in consonance with generally accepted accounting principles (GAAPs) and Accounting Standards. If not, what is the correct treatment?

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting for the expenditure (referred to by the querist as peripheral development expenses (CSR expenses)) incurred by the company during construction/development of power project and coal mines, as a pre-condition to obtaining environmental clearance in respect of power project and coal mines (hereinafter referred to as the ‘expenditure’). Accordingly, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, expenditure incurred on exploration and development of coal mine project, expenditure on development of power project, etc. The Committee also wishes to mention that the Committee has not examined the accounting treatment of peripheral development expenses (CSR expenses) incurred by the company after the development of the power project and coal mines as the issue is not raised by the querist. The Committee has also not examined whether the expenditure meets the requirements of CSR expenses as prescribed under various laws, such as, Companies Act, 2013, Regulations, Guidelines, etc. and the opinion is purely from accounting perspective. The Committee has also not examined the details of expenditure incurred and has presumed that the company is incurring the expenditure as per the directions/instructions of the Ministry of Environment and Forest. Further, since the query is related to the power and coal mines development project, it is presumed that for capitalisation purpose, the whole project is being considered as a unit of measurement.

10. The Committee notes from the Facts of the Case that the company in question has obtained environmental clearance from the Ministry for
development of coal mine and power project and as a condition to such clearance, the company has to incur the expenditure referred. In this regard, the Committee also notes the requirements of the environmental clearance for the coal mine and power project, respectively as follows:

*Environmental clearance for Power Project*

“...the Ministry of Environment and Forests hereby accords environmental clearance to the above project under the provisions of EIA notification dated September 14, 2006, subject to the compliance of the following conditions:

...  

(xxiv) An amount of Rs. 24.36 Crores shall be earmarked as one time capital cost for CSR programme. Subsequently a recurring expenditure of Rs. 4.87 Crore per annum shall be earmarked as recurring expenditure for CSR activities. ...

“The Ministry of Environment and Forests reserves the right to revoke the clearance if conditions stipulated are not implemented to the satisfaction of the Ministry. The Ministry may also impose additional environmental conditions or modify the existing ones, if necessary.”

*Environmental clearance for Coal Mine Project*

“2. ... The proponent has informed that:

...  

xx. The CSR cost has been calculated @ Rs. 5/Te for 152.12MT mineable reserves amounting to Rs. 7606 Lakh. The CSR expenditure of Rs. 84.35 Lakh till date has been made on education, health, infrastructure, water, sports & culture, Social welfare etc.”

“3. ... The Ministry of Environment & Forests hereby accords environmental clearance... under the provisions of the Environmental Impact Assessment Notification, 2006 and subsequent amendments thereto subject to the compliance of the terms and conditions mentioned below:
A. Specific Conditions:

ix. The CSR amount should be Rs. 4 crores in initial 3 years, and thereafter it should be Rs. 5/T of coal/annum till the end of the life of project with escalation factor every year coal production."

"8. Failure to comply with any of the conditions mentioned above may result in withdrawal of this clearance and attract the provisions of the Environment (Protection) Act, 1986."

The Committee further notes the following paragraphs of AS 10, notified under the Companies (Accounting Standards) Rules, 2006:

"9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

(i) site preparation;
(ii) initial delivery and handling costs;
(iii) installation cost, such as special foundations for plant; and
(iv) professional fees, for example fees of architects and engineers.

"10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs."

From a wholesome reading of the above paragraphs of AS 10, the Committee is of the view that the basic principle to be applied while capitalising an item of cost to a fixed asset/project under construction is that it should be directly attributable to the construction of the project/fixed asset for bringing it to its
working condition for its intended use, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. Accordingly, in the extant case, the Committee is of the view that it should be seen that whether the expenditure is directly attributable to the construction as discussed above. The Committee notes that in the extant case, incurrence of the expenditure is a specific pre-condition for the environmental clearance for the development of the coal mine and power projects and in case this expenditure is not incurred, it may result in withdrawal of the environmental clearance and attract the penalties as per the provisions of the Environment (Protection) Act, 1986. Accordingly, in the view of the Committee, the expenditure should be considered as directly attributable to the development/construction of the coal mine and power projects for bringing them to their working condition for their intended use. Therefore, the Committee is of the view that the expenditure to the extent required to be incurred for obtaining environmental clearance should be capitalised as a part of the cost of the coal mine and power project. With regard to the accounting policy of the company for treatment of such expenditure, the Committee notes from paragraph 4 above that the same is booked under the head ‘Peripheral Development’ and grouped under the ‘Expenditure During Development / Construction of Power Project’ and ‘Expenditure During Development Coal Mines’ which will be capitalised on commissioning of the project/coal mines. The Committee is of the view that since the expenditure is to be capitalised, the same should be capitalised initially as ‘capital work-in-progress’ as and when incurred with a suitable disclosure in the notes to accounts to explain the nature of such expenses and then recognised as a part of the cost of the related project/asset account as and when the project is ready for commencement of commercial production.

D. Opinion

11. On the basis of the above, the Committee is of the opinion that capitalising the expenditure incurred as a pre-condition to obtaining environmental clearances as a part of the cost of power project and coal mines and not recognising the same in the statement of profit and loss is appropriate and is in consonance with generally accepted accounting principles (GAAPs) and Accounting Standards. However, the expenditure should initially be capitalised as ‘capital work-in-progress’ as and when incurred with a suitable disclosure in the notes to accounts to explain the nature of such expenses and then recognised as a part of the cost of the
related project/asset account as and when the project is ready for commencement of commercial production, as discussed in paragraph 10 above.

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Query No. 3

Subject: Amortisation of SAP license and accounting for annual renewal fee.¹

A. Facts of the Case

1. A company incorporated as a wholly owned Government company under the Companies Act, 1956 during the year 1984-85 is engaged in construction and operation of thermal power plants in the State of Odisha. The company had set up two power plants of 2 x 210 MW (units I and II that is 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. Power generated from units I and II is sold to A Ltd, a Government of Odisha Undertaking at a tariff determined as per Bulk Power Purchase Agreement executed during 1996. During 1999, as a part of power sector reforms, the Government of Odisha disinvested 49% of the shares in favour of ABC 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. During the year 2008-09, the company has issued Request for Proposal (RFP) for inviting offers from bidders for ‘Implementation of SAP ERP, Non-SAP Applications and related IT Infrastructure along with Post-implementation support with Facility Management’. In the bidding process, SAP licenses with perpetual rights were procured from M/s SAP India at a cost of Rs. 69 lakh for implementation of SAP ERP. Besides above, annual licence fee of Rs. 16 lakh, revised from time to time, is payable every year. However, due

¹ Opinion finalised by the Committee on 23.4.2015.
to some internal issues, evaluation of bids for awarding of contract for
appointment of agency, procurement of the non-SAP application and related
IT infrastructure along with post-implementation support with facility
management could not be completed and SAP licence could not be used in
the absence of implementation of SAP.

3. Relevant conditions granted by the SAP India as per ‘SAP Software
End-User Value License Agreement’ are given below. This agreement was
signed between SAP India and the company on procurement of SAP licenses:

“(a) SAP grants, a non-exclusive, perpetual (unless terminated in
accordance with Section 5 herein) license to use the Software,
Documentation, other SAP Proprietary Information, at specified
site(s) within the Territory to run Licensee’s internal business
operations and to provide internal training and testing for such
internal business operations and as further set forth in Appendices
hereto. This license does not permit Licensee to (i) sub-license
or rent the Software or Documentation or (ii) use the SAP
Proprietary Information to provide services to third parties (e.g.,
business process outsourcing, service bureau applications or third
party training). Business Partners may have screen access to
the Software solely in conjunction with Licensee’s Use and may
not Use the Software to run any of their business operations.

(b) Licensee agrees to install the Software only on hardware identified
by Licensee pursuant to this Agreement that has been previously
approved by SAP in writing or otherwise officially made known to
the public as appropriate for Use or inter-operation with the
Software (the “Designated Unit”). Designated Units may not be
shared for the purposes of Software Use with companies/entities
that are not defined as Licensee or authorized Affiliates hereunder.
Any individuals that use the Software including employees or
agents of Affiliates and Business Partners, must each be licensed
as a Named User. Use may occur by way of an interface delivered
with or as a part of the Software, a Licensee or third-party
interface, or another intermediary system.”

The querist has separately clarified that perpetual rights of SAP licenses
mean that the licence will continue unless terminated as per clause 5 of the
‘SAP Software End-User Value License Agreement’ (a copy of which has
been supplied by the querist for the perusal of the Committee). Further,
annual renewal fee is payable as per the agreement for the enterprise support and applicable from the effective date of agreement. If annual fee is not paid for updating the license, there would be violation/breach of the ‘SAP Software End-User Value License Agreement’ and accordingly, it may result into the cancellation of SAP license as per the agreement. The fee is only paid as per the terms and conditions of contract. Practically, no service is received against such payment.

4. As per clause 5.1. of the agreement, “This Agreement and the license granted hereunder shall become effective as of the date first set forth above and shall continue in effect thereafter unless terminated upon the earliest to occur of the following: (i) thirty days after Licensee gives SAP written notice of Licensee’s desire to terminate this Agreement, for any reason, but only after payment of all License and Maintenance Fees then due and owing; (ii) thirty days after SAP gives Licensee written notice of Licensee’s material breach of any provision of the Agreement (other than Licensee’s breach of its obligations under Sections 6 or 10, which breach shall result in immediate termination), including more than thirty days delinquency in Licensee’s payment of any money due hereunder, unless Licensee has cured such breach during such thirty day period; (iii) immediately if Licensee files for bankruptcy, becomes insolvent, or makes an assignment for the benefit of creditors”.

5. On procurement of SAP ERP license during the year 2008-09, an amount of Rs. 69 lakh was booked to ‘Capital Work in Progress (CWIP)’ account and kept for capitalisation along with SAP implementation.

6. Statutory auditors of the company during their audit for the year 2009-10 have given the following observation on accounting of SAP ERP licenses under the head ‘Capital Work in Progress’:

“CWIP includes Rs. 68.79 lakh for the SAP license fees paid in December 2008 which is not capitalised and hence not amortised due to the absence of any accounting policy for such expenditure in view of annual maintenance charges being paid for the year 2009 and 2010. Such license in the nature of intangible asset is available for use even though not implemented and as per Accounting Standard (AS) 26 ‘Intangible Assets’, intangible asset’s amortization should commence from the time the asset is available for use.” (Emphasis supplied by the querist.)
Based upon above observation of the statutory auditors, expenses incurred towards procurement of SAP licenses have been capitalised during the year 2010-11 and amortised from the year 2009-10 as per the following significant accounting policy of the company:

“Cost of computer software recognised as intangible asset is amortised on straight line method over a period of legal right to use subject to maximum ten year.”

7. The querist has stated that the Comptroller and Auditor General (C&AG) of India, while conducting supplementary audit under section 619(3) of the Companies Act, 1956 for the financial years 2012-13, has raised observations on accounting treatment of SAP ERP licenses on the basis of observation of statutory auditors for the year 2009-10. The observations of C&AG of India and replies of management are given below:

<table>
<thead>
<tr>
<th>Observations</th>
<th>Replies of Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangible Assets (Note-11)</td>
<td>Software and SAP license (Net) – Rs. 46.65 lakh</td>
</tr>
<tr>
<td>The company paid Rs. 0.69 crore towards license fee in February 2009, and capitalised the amount during the year. Further, Rs. 0.68 crore was annually paid towards Annual Enterprise Support (AES) fee for software and SAP maintenance upto March 2013 and charged to profit &amp; loss accounts in these years. As the required software was not procured and installed as on the date of the balance sheet entire expenditure on this account should have been booked to capital works in progress. This has resulted in</td>
<td>Observation of audit that the software not procured is not correct. The company procured the SAP ERP ECC 6.0 software licence from SAP India for implementation of the SAP project and the end user licence agreement (EULA) was signed between the company and SAP India on 27th December, 2008 on payment of Rs. 68.79 lakhs. The License is for unlimited period and updated only on payment of Annual Enterprise Support fee. On signing of agreement, the software covering modules such as FICO, MM, PM, PS, HR, Pay Roll, ESS etc. were received by the company.</td>
</tr>
</tbody>
</table>

As per paragraph 63 of AS 26, the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful
understatement of capital work-in-progress by Rs. 1.37 crore, profit for the period by Rs. 0.96 crore and overstatement of fixed assets by Rs. 0.41 crore (net of depreciation Rs. 0.28 lakh).

life of an intangible asset will not exceed ten years from the date when the asset is available for use. **Amortisation should commence when the asset is available for use.**

Since the asset is available for use, the company accepted observations of statutory auditors (accounts for the year 2009-10) and based upon their advice amortised the same over ten years in compliance to AS 26.

There is no understatement of Capital Work-in-Progress by Rs. 1.37 crore, profit for the period by Rs. 0.96 crore and overstatement of fixed assets by Rs. 0.41 crore (net of depreciation Rs. 0.28 lakh).

(Emphasis supplied by the querist.)

8. Similarly, C&AG of India, while conducting supplementary audit under section 619(3) of the Companies Act, 1956 for the financial year 2013-14, has raised draft observations which were also replied in line with the replies for the year 2012-13. C&AG of India instead of retaining the observation has informed the following vide its letter dated 28.08.2014:

“In course of supplementary audit of the above mentioned accounts, it is pointed out, (POM-3) that to obtain end user license for SAP ERP 6.0 software, the company signed end user licence agreement with M/s SAP India on 27.12.2008 and paid Rs. 68.79 lakh on 16.02.2009. In terms of the end user license agreement, the company was to pay annual enterprise support fee @ 22 percent of the license fee excluding taxes. The company capitalized the intangible asset at Rs. 68.79 lakh during the year 2008-09 on the ground that after payment of the license fee, the asset was available for use. In this context the observation of the statutory auditors on the annual accounts 2009-10 was accepted by the company and based on their advice the company amortised the same over a period of ten years from the year 2008-09 citing compliance to AS 26.

However, scrutiny of records revealed that till 31st March, 2014, the implementation of SAP ERP could not be made for selection of partner.
Thus, the asset was not ready to use even by the end of the financial year 2013-14. The payments made for acquisition of end user license as well as for the annual enterprise support fee should have been debited to CWIP instead of charging to statement of profit and loss. In the absence of implementing agency, the asset though available with the company but was not ready to use. Hence, the criteria for recognition of intangible assets as per AS 26 are not met. The amount incurred should have been booked under Capital Works in Progress till the asset is ready to use.

The above observation may be considered and necessary accounting effect may be given during finalisation of accounts for the F.Y. 2014-15.”

9. In this regard, the opinion on Query No. 2 of Volume XXVI of the Compendium of Opinions, issued by the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) has been referred to by the querist. As per the opinion of the Expert Advisory Committee, the expenditure incurred on or after 1.04.2013 regarding SAP license fees and any further expenditure should be recognised as intangible assets as per paragraph 10 of AS 26 and amortised over the period of life.

10. The querist has further stated that subsequently, the company invited the bids during the year 2014-15 for “appointment of Agency for Implementation of SAP ERP, Non-SAP Applications and related IT Infrastructure along with Post-Implementation support with Facility Management at the company” and evaluation of technical offers is in progress.

B. Query

11. In view of above facts and accounting requirement, the company seeks the opinion of the Expert Advisory Committee as to whether capitalisation of expenses on SAP ERP licenses and amortisation of the same over a period of 10 years as per the accounting policy in this regard and charging of the annual renewal fee to the statement of profit and loss before implementation of the SAP on the basis of observations of the statutory auditors for the year 2009-10 is in consonance with the Generally Accepted Accounting Principles and provisions of Accounting Standard (AS) 26, ‘Intangible Assets’. If not, what would be the accounting treatment?
C. Points considered by the Committee

12. The Committee notes that the basic issues raised in the query relate to the timing of commencement of amortisation of expenditure incurred on acquisition of SAP ERP licenses as a part of intangible asset as per the principles of AS 26; and accounting for annual enterprise support or renewal fee (hereinafter referred to as the ‘renewal fee’) incurred by the company subsequent to the acquisition of such licenses. Accordingly, the Committee has considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, method of amortisation, determination of useful life for amortisation of SAP ERP licenses, legal interpretation of SAP Software End-User Value License Agreement, etc.

13. The Committee notes from the Facts of the Case that the company has acquired SAP ERP license from SAP India during the year 2008-09, which could not be implemented due to some internal issues related to non-completion of technical evaluation of bids for awarding of contract for appointment of agency, procurement of the non-SAP application and related IT infrastructure along with post-implementation support with facility management (hereinafter referred to as ‘non-SAP applications and facilities’). The Committee further notes that the company capitalised the SAP ERP license as an intangible asset on the advice of the statutory auditors and is amortising the same even though, it could not be implemented. However, the C&AG is of the view that since the software has not been installed and since implementation of SAP ERP could not be made for selection of partner for non-SAP applications and facilities, the asset though available with the company but was not ready to use and, therefore, the expenditure incurred on acquisition should have been booked as ‘capital work in progress’ till the asset is ready to use. Accordingly, as per the views of the C&AG, the company should not also commence amortisation of such expenditure. In this regard, the Committee notes paragraph 63 of Accounting Standard (AS) 26, ‘Intangible Assets’, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the ‘Rules’):

“63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.”
The Committee notes from the above that amortisation should begin when the asset is ‘available for use’. The Committee is of the view that the term ‘available for use’ should be construed to mean when the asset is in the condition and location necessary for it to be capable of operating for its intended use. Therefore, in the extant case, the Committee is of the view that the company should determine when the license is in the condition necessary for it to be capable of operating for its intended use. In this regard, the Committee notes from the Facts of the Case that the license cannot be used till the non-SAP applications and facilities are also ready. Thus, SAP license cannot be used independently in the absence of Non-SAP applications and facilities and therefore, the implementation of SAP license is a composite arrangement requiring both SAP and Non-SAP applications and facilities. Accordingly, considering the above requirements of AS 26, SAP license can be considered to be ‘available for use’ only when Non-SAP applications and facilities are also ready. Therefore, the Committee is of the view that till the SAP license is not ‘available for use’ as discussed above, the same should be classified as ‘intangible asset under development’ in the financial statements and thereafter it should be recognised as a part of the ‘intangible asset’. Thus, the treatment made by the company in this regard is not appropriate. In this context, the Committee also wishes to point out that apart from the above-mentioned accounting treatment, the company should also assess at each balance sheet date whether there is any indication that the asset recognised as above may be impaired considering the requirements of Accounting Standard (AS) 28, ‘Impairment of Assets’, notified under the Rules. Moreover, it is imperative to note that as stated in paragraph I (14) of Illustration A of AS 26, “there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, given the history of rapid changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is likely that useful life of the software will be much shorter, say 3 to 5 years.” Accordingly, irrespective of the impairment assessment performed under AS 28, the company should assess the technological obsolescence of the SAP license and recognise an appropriate write down, as required.

14. With regard to accounting for annual renewal fee incurred by the company subsequent to the acquisition of such licenses, the Committee notes the following paragraphs of AS 26:
"59. Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

60. Subsequent expenditure on a recognised intangible asset is recognised as an expense if this expenditure is required to maintain the asset at its originally assessed standard of performance. The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. In addition, it is often difficult to attribute such expenditure directly to a particular intangible asset rather than the business as a whole. Therefore, only rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset."

From the above, the Committee is of the view that subsequent expenditure on renewal of license should be expensed if it is required only to maintain the asset at its originally assessed standard of performance and only that expenditure can be capitalised which enables the asset to generate future economic benefits in excess of its originally assessed standard of performance. The Committee notes from the Facts of the Case that the querist has specifically stated that the fee is only paid as per the terms and conditions of contract and practically, no service is received against such payment. Further, if annual fee is not paid for updating the license, there would be violation/breach of the ‘SAP Software End-User Value License Agreement’ and accordingly, it may result into the cancellation of SAP license as per the agreement. Accordingly, the Committee is of the view that annual fee in the extant case is a period cost which is incurred to continue to retain
the license and does not generate future economic benefits in excess of originally assessed standard of performance of the license. The Committee is also of the view that although the annual renewal fee may be incurred during the period when the license is in the process of being made 'available for use', i.e., being processed to be placed in the condition and location necessary for it to be capable of operating for its intended use, but it is not an expenditure to make the asset 'available for use'. Accordingly, the Committee is of the view that the expenditure on annual renewal fee cannot be capitalised and should be expensed in the statement of profit and loss. Thus, the accounting treatment made by the company in this regard is appropriate.

D. Opinion

15. On the basis of the above, the Committee is of the view that the SAP license can be considered to be 'available for use' only when Non-SAP applications and facilities are also ready. Therefore, till the SAP license is not 'available for use', as discussed in paragraph 13 above, the same should be classified as 'intangible asset under development' and thereafter it should be recognised as part of the 'intangible asset'. Further, as discussed in paragraph 13 above, such SAP license should be tested for impairment and write down for technological obsolescence. Thus, the treatment made by the company in this regard is not appropriate. The expenditure on annual renewal fee in the extant case is incurred to continue to retain the licence and does not generate future economic benefits in excess of originally assessed standard of performance of the license. Thus, it cannot be capitalised and should be expensed in the statement of profit and loss. Thus, the accounting treatment made by the company in this regard is appropriate, as discussed in paragraph 14 above.
Query No. 4

Subject: Provisioning for doubtful receivables.¹

A. Facts of the Case

1. X, a company incorporated in India is a joint venture between an Indian entity and a foreign company. The foreign company has various joint ventures other than the instant case. The foreign company has the following accounting methodology relating to the provisioning for doubtful receivables of all its Asia Pacific business units:

   Accounting Policy

   “Purpose

   The purpose of this policy is to document the proper accounting methodology related to Allowance for Doubtful Accounts for all Asia Pacific’s business units.

   Procedure

   The provision for estimated losses on accounts receivable may be estimated by an acceptable formula (i.e., as a percentage of sales for the period or a percentage of accounts receivable at the end of the period). An acceptable formula is practical and acceptable, but the appropriateness of the formula must be checked periodically by a judgmental evaluation of the collectability of the receivables themselves. The estimated loss should be compared with the current balance in the allowance for doubtful accounts, with the difference being debited or credited to the bad debt provision.

   The analysis of the allowance for doubtful accounts must be performed at least quarterly and as of December year-end. However, accounts receivable balances are reviewed monthly for unusual or significant activity to ensure that material adjustments are captured on a timely basis. The analysis should include, at a minimum, review of individually significant accounts and review of an aging analysis that lists each individual account item according to the period of time it has been outstanding. The analysis shall be:

¹ Opinion finalised by the Committee on 23.4.2015.
Specific Provision

The specific provision review shall take into account things such as:

- Bankruptcies
- Customers out of business
- High risk accounts

When a customer declares bankruptcy, a provision is established and is typically 100% on the pre-petition amount outstanding. The amount of provision required for ‘customers out of business’ or ‘high risk accounts’ is a matter of judgment and credit/collections collaborates with the business unit on the appropriate provision to establish. If a non-receivable is fully provisioned, the company should no longer record interest income.

General Provision

- Applied predetermined percentages against each of the aging buckets,
- Applied against balances after deducting specific provision,
- Percentages determined based on historical analysis,
- Percentages differ by business unit due to type of customers,
- Percentages should be consistently applied each quarter, and
- Percentages should be reviewed annually

2. The querist has stated that as per section A2 of Accounting Policy Memo, it is the responsibility of the business unit vice-president to manage the accounting activities of the region. These responsibilities include but are not limited to:

- ensure that financial statements and operating reports are prepared accurately and promptly in conformity with accounting policies.
- ensure that financial and operating controls are cost effective and are adequate to safeguard assets and the integrity of the financial reporting system.
3. As per review of outstanding amounts due to the Asia Pacific entities, 60 to 90 days appear to be the standard timeframe to collect payment. As such, to more accurately reflect the financial position of Asia Pacific entities, the Asia Pacific region will use the percentages below when reviewing the general provision for doubtful accounts:

<table>
<thead>
<tr>
<th>Days Past Due</th>
<th>% Provisioned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>0%</td>
</tr>
<tr>
<td>1-30</td>
<td>0%</td>
</tr>
<tr>
<td>31-60</td>
<td>0%</td>
</tr>
<tr>
<td>61-90</td>
<td>10%</td>
</tr>
<tr>
<td>91-180</td>
<td>15%</td>
</tr>
<tr>
<td>181-360</td>
<td>50%</td>
</tr>
<tr>
<td>360+</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Provision calculated quarterly**

- Calculated based on accounts receivable balances each quarter-end and for December, as of Annual Report (AR) close.

- Meetings scheduled to review analysis details with Chief Financial Officer (CFO) and Financial Planning and Analysis (FP&A) during quarter-end close week.

- Record adjustments before quarter-end close (or on a monthly basis when significant or material event triggers a need for an adjustment to the provision).

**Recording of bad debt provision**

- Budget or forecast is used as a standard entry each month.

- Additional provision may be recorded monthly or quarterly based on the provision analysis results.

4. **Write-Offs**

When it is determined that a specific account is uncollectible and should be
written off, accounts receivable and the allowance are reduced. If it is determined that only part of a particular debt is collectible, the uncollectible amount should be written off. Accounts receivable write-offs are not to be charged directly to income statement.

Write-off approvals

<table>
<thead>
<tr>
<th>Authorisation Limit</th>
<th>Job Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to USD 100,000</td>
<td>Business-unit Vice President of finance</td>
</tr>
<tr>
<td>Up to USD 250,000</td>
<td>Business-unit President</td>
</tr>
<tr>
<td>Up to USD 1,000,000</td>
<td>Chief Operating Officer (COO)</td>
</tr>
<tr>
<td>Over USD 1,000,000</td>
<td>Investment Committee</td>
</tr>
</tbody>
</table>

5. **Recoveries**

Collections on accounts previously written off are added to the allowance for doubtful accounts. Bad debt recoveries are not credited to income statement accounts unless specifically approved by the vice president and chief accounting officer.

6. **Financial Reporting Package Disclosure**

The following Financial Reporting Package (FRP) schedules are required for the allowance for doubtful accounts:

- Accounts Receivable Aging
- Allowance for Doubtful Accounts

7. **Implementation**

This policy is applicable for any financial year in which audited financials have not been issued before the effective date noted above.

B. **Query**

8. On the basis of the above, the opinion of the Expert Advisory Committee has been sought by the querist on the following issues:

   (i) Can a company adopt an accounting policy to allow for doubtful receivable based on ageing?
(ii) Whether such an accounting policy would be in compliance of Accounting Standard (AS) 1, ‘Disclosure of Accounting Policies’.

(iii) Whether such an allowance impact ‘true and fair’ nature of the accounts.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to whether provision on doubtful receivables can be made on the basis of ageing of accounts receivables. Accordingly, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, procedure followed for determining the ageing of accounts receivables, accounting for collections against the bad debts written off, viz., bad debt recoveries, policy relating to writing-off of bad debts and the related approval required, etc.

10. With regard to provisioning for bad and doubtful debts, the Committee notes that paragraph 7 of Accounting standard (AS) 29, ‘Provisions, Contingent Liabilities and Contingent Assets’, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the ‘Rules’) inter alia, states that “The term ‘provision’ is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard”. The Committee further notes that doubtful debt is a contingency and the same is covered under the principles of Accounting Standard (AS) 4, ‘Contingencies and Events Occurring After the Balance Sheet Date’ notified under the ‘Rules’. In this regard, the Committee notes the following paragraphs of AS 4:

“3.1 A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.”

“4.1 The term “contingencies” used in this Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.”

“5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency
will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements."

“10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and

(b) a reasonable estimate of the amount of the resulting loss can be made.

11. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote."

From the above, the Committee is of the view that doubtful debts is a contingency and accordingly, a provision in respect thereof should be made in the extant case if based on the facts and circumstances, impairment of receivables account is probable and a reasonable estimate of the amount of resulting loss can be made. With regard to the amount of provision to be provided for in respect of doubtful receivables, the Committee notes the following paragraphs of AS 4, notified under the ‘Rules’:

“4.4 The estimates of the outcome and of the financial effect of contingencies are determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.”

“5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4.”

“7.1 The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been
impaired, or that a liability may have existed, at the balance sheet date
are, therefore, taken into account in identifying contingencies and in
determining the amounts at which such contingencies are included in
financial statements.

7.2 In some cases, each contingency can be separately identified,
and the special circumstances of each situation considered in the
determination of the amount of the contingency. A substantial legal
claim against the enterprise may represent such a contingency. Among
the factors taken into account by management in evaluating such a
contingency are the progress of the claim at the date on which the
financial statements are approved, the opinions, wherever necessary,
of legal experts or other advisers, the experience of the enterprise in
similar cases and the experience of other enterprises in similar
situations.

7.3 If the uncertainties which created a contingency in respect of an
individual transaction are common to a large number of similar
transactions, then the amount of the contingency need not be
individually determined, but may be based on the group of similar
transactions. An example of such contingencies may be the estimated
uncollectable portion of accounts receivable. Another example of such
contingencies may be the warranties for products sold. These costs
are usually incurred frequently and experience provides a means by
which the amount of the liability or loss can be estimated with
reasonable precision although the particular transactions that may result
in a liability or a loss are not identified. Provision for these costs
results in their recognition in the same accounting period in which the
related transactions took place."

"8.1 Events which occur between the balance sheet date and the
date on which the financial statements are approved, may indicate the
need for adjustments to assets and liabilities as at the balance sheet
date or may require disclosure.

8.2 Adjustments to assets and liabilities are required for events
occurring after the balance sheet date that provide additional information
materially affecting the determination of the amounts relating to
conditions existing at the balance sheet date. For example, an
adjustment may be made for a loss on a trade receivable account
which is confirmed by the insolvency of a customer which occurs after the balance sheet date."

From the wholesome reading of the above paragraphs, the Committee notes that the amount to be provided for in respect of doubtful receivables should be determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts. If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. On the basis of the above, the Committee is of the view that the amount in respect of a provision for doubtful receivables should be determined considering the various factors, as discussed above and should not be determined solely on the basis of an acceptable formula, which is based on the percentage of sales or percentage of account receivable considering the ageing of receivables, although such acceptable formula is practically convenient. Further, events occurring after the reporting/balance sheet date that provide additional information materially affecting the determination of the amounts of doubtful provisions, such as insolvency of a receivable, etc. should also be considered and accordingly, adjustments should be made in the amount of provisions for doubtful receivables. In this regard, the Committee notes that the company in the extant case, while determining the percentage of provision takes into consideration historical analysis considering the type of customers and a judgemental evaluation of the collectability of the receivables is also made periodically. Thus, it appears that in the extant case, the company takes into consideration not only ageing but also other relevant factors, as discussed above. Accordingly, the Committee is of the view that if the policy of the company to provide for doubtful receivables takes into consideration various factors, as discussed above, the same would be in compliance of various Accounting standards and would also depict true and fair view of the accounts.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 8 above:
(i), (ii) and (iii) The company should adopt an accounting policy in respect of provision for doubtful receivables based on various factors as discussed in paragraph 10 above and should not be based solely on ageing of the receivables. If the policy of the company to provide for doubtful receivables takes into consideration various factors, as discussed above, the same would be in compliance of various Accounting Standards and would also depict true and fair view of the accounts.

Query No. 5

Subject: 1. Accounting treatment of pre-operative and preliminary expenses incurred on formation and incorporation of the company.

2. Accounting treatment of finance cost and other pre-operative expenses incurred during pre-operative period.

3. Accounting for interest earned on fixed deposits made out of idle funds, interest earned on mobilization advance and other miscellaneous income during pre-operative period.¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the company’) is a special purpose vehicle (SPV) of the Government of India, promoted at the behest of the Ministry of Finance, Govt. of India, jointly by S Limited, a Government of India enterprise and B Limited, a wholly owned subsidiary of the Reserve Bank of India (RBI) as equal partners to implement a greenfield strategic project of national importance of setting up of a bank note paper mill for manufacturing currency paper and other security paper with a capacity of 12000 TPA (two lines of 6000 TPA each) at the existing premises of B Ltd.

2. The company was incorporated in October 2010 as a standalone private limited company as per the provisions of the Companies Act, 1956. It has an independent board of directors nominated equally by the joint venture

¹Opinion finalised by the Committee on 3.6.2015.
(JV) partners. As clarified by the Ministry of Corporate Affairs through Ministry of Finance, Government of India, the company is treated as a special purpose vehicle of the Government of India and accordingly, provisions of section 619(B) of the Companies Act, 1956 (corresponding section 139(5) and (7) of the Companies Act, 2013) are attracted. Accordingly, statutory auditor of the company is appointed by the Comptroller and Auditor General of India (C&AG), New Delhi.

3. The estimated capital cost of the project of around Rs. 1500 crore is being funded by equity capital to the extent of Rs. 600 crore and the balance by long term bank finance. The JV partners have already contributed to equity capital in three tranches of Rs. 100 crore each by each of them and as on 31st March, 2014, the paid up capital of the company stands at Rs. 600 crore (contributed @ Rs. 300 crore each by the JV partners). The company has also completed financial closure with the arrangement of long term rupee loan of around Rs. 900 crore in multiple banking arrangement. The project on implementation will substitute import of bank note paper/currency note paper substantially.

4. The querist has stated that the company has been in the construction phase since its first financial year commencing from the date of incorporation and ending on March 31st, 2011 and the year ended March 31st, 2014 is the 4th accounting period in the construction phase. The company is still in the construction phase as on date and is expected to commence commercial production in the later part of financial year 2015-16.

5. The project of setting up of a bank note paper mill was originally conceived by B Ltd. (which, later on, became one of the JV promoters of the company) to be set up at its existing premises of bank note printing press at Mysore, Karnataka as a strategy of backward integration and accordingly, preparatory work started much earlier than the date of incorporation of the company. Subsequently, the Ministry of Finance, Government of India, decided that the proposed bank note paper/security paper mill would be implemented by establishing a 50:50 joint venture between S Ltd. and B Ltd. in the existing premises of B Ltd. Pending incorporation of the company, at the behest of the Ministry of Finance, Government of India, a Joint Management Committee (JMC) was formed comprising members from S Ltd., B Ltd. and the Ministry of Finance to prepare a road map to decide capacity of production and to take decision on mode of financing, etc. Accordingly, the JMC started functioning with the assigned tasks to take the
project forward. The foundation stone was unveiled ceremoniously on 22\textsuperscript{nd} March, 2010 at the project site by the then Union Finance Minister in the presence of the then Governor, Reserve Bank of India and other dignitaries. Thereafter, the company was formed in October 2010 to take over the project on as is basis for its implementation. On incorporation, the company took over the preliminary and preoperative expenditure of Rs. 8,27,07,706/- partly funded by B Ltd. and partly by S Ltd. and adopted/renewed all existing contracts as was necessary to implement the project.

6. The company formation and registration expenses, share issue expenses towards stamp duty etc. included in the preliminary and preoperative expenses amounting to Rs. 2,57,57,020/- have been charged off to the statement of profit and loss and other expenses relating to the project incurred in the pre-incorporation period have been capitalised under the head ‘preoperative expenses pending allocation’. In the first financial year ended March 31, 2011, the JV promoters contributed @ Rs. 100 crore each net of preliminary and preoperative expenses incurred by them respectively. In the 3\textsuperscript{rd} financial year ended March 31, 2013, the JV promoters contributed Rs. 200 crore each in two tranches towards equity contribution and then, the paid up equity capital stood at Rs. 600 crore as on March 31, 2013, and the paid up capital stood at the same level on March 31, 2014.

7. Pending disbursement of funds towards acquisition and construction of project assets, the company parked the unspent money out of equity capital in fixed deposit with banks and renewed from time to time depending upon the project cash outflow. Thus, the company has earned interest income during construction period upto March 31, 2014 amounting to Rs. 68,08,40,636/-. Besides, the company has also earned interest on mobilisation advance of Rs. 1,54,58,811/- and other miscellaneous receipts of Rs. 25,88,834/-. The stated income and the construction of the project being inextricably linked, the same has been capitalised and adjusted with preoperative expenses. The querist has separately clarified that in order to have a quick start-up of the project, it was proposed and the company paid mobilisation advance to the extent of 10% of the civil & structural value and Effluent Treatment Plant (ETP) value to the civil contractor and ETP construction contractor, respectively with the following conditions:

a. The above advance will carry simple interest of 10% per annum; and
b. The recovery of the advances will be from each running account bill on a pro rata basis.

The querist has also stated that relying on the following favourable judgments, the company has not provided for income tax, if any, on such interest income earned during the construction period:

a. Karnal Co-operative Sugar Mills Limited Vs CIT (SC)

b. CIT Vs Bokaro Steel Ltd (SC)

c. CIT Vs Karnataka Power corporation (SC)

d. Indian Oil Panipat Power Consortium Limited Vs ITO (HC)

e. NTPC Sail Power Company Private Limited Vs CIT (HC)

f. CIT Vs VGR Foundations (HC)

As an abundant precaution, the company has, however, deposited advance tax on self-assessment basis and disclosed the same under the head ‘Loans & Advances’ in the balance sheet.

8. The querist has stated that the company has actually started availing of long term bank finance only in the later part of the financial year 2013-14 and incurred an interest expenditure of Rs 3,40,09,846/- as on March 31, 2014 which is capitalised as it is directly related to acquisition and construction of fixed assets. Since the company is implementing the greenfield project and constructing the same from scratch and the only business activity being related to construction of the project, administrative and general overhead expenses incurred during the construction period being incidental to the construction have been capitalised and accumulated under the head ‘Preoperative Expenditure Pending Allocation’. Expenses which are purely general and corporate in nature such as formation expenses, share issue expenses, audit fees, filing fees, directors sitting fees etc. have been charged off to the statement of profit and loss. Expenditure which are directly attributable to the project, such as, project consultancy fees, preparation of DPR cost, various fees for approvals etc. are directly capitalised under the head ‘preoperative Expenses’. Upon successful commissioning of the project, the preoperative expenses which are directly identified with an asset will be capitalised along with that particular asset and other preoperative expenses will be apportioned on a suitable basis. A
statement of preoperative expenses incurred year wise and the total accumulation as on March 31, 2014 under various heads of accounts has been supplied by the querist as Annexure 1.

9. The company is consistently following the accounting practices as above in terms of Accounting Standards – Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’\(^2\), AS 16, ‘Borrowing Costs’ and AS 26, ‘Accounting for Intangible Assets’ as well as Guidance Note on Treatment of Expenditure During Construction Period\(^3\), issued earlier by the Institute of Chartered Accountants of India, to the extent these are not contrary to the provisions of the Accounting Standards. However, the Government auditor raised a preliminary enquiry during the audit of the accounts for the financial year 2013-14 as under:

1. Capital work in progress (CWIP) Rs. 469.68 crore

   a. This does not include Rs. 3,25,844 being the expenses relating to directors’ sitting fees and auditors’ fee (Note -13). As per AS 10, paragraph 9.2, administration and other general overhead expenses as are specifically attributable to construction of a project be included as part of the cost of the construction project or as a part of the cost of the fixed assets.

   Non-inclusion of the same under CWIP resulted in understatement of capital WIP, understatement of reserves and surplus by Rs. 3.25 lakh.

   b. Further, an amount of Rs. 3.23 crore is appearing as opening balance under reserves and surplus (deficit) which relates to the accumulated loss at the beginning of the year. Since the project is under construction, all the expenditure whether it relates to specific cost identifiable to project or general expenditure should be included under project cost/capital work in progress. The same

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\(^2\)The opinion should be read in the context of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, which has been revised as AS 10, ‘Property, Plant and Equipment’ by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.

\(^3\)The Guidance Note on Treatment of Expenditure during Construction Period has been withdrawn by the Council of the Institute of Chartered Accountants of India vide its decision at its 280th meeting held on August 7-9, 2008.
may be reviewed and necessary adjustments in the books may be carried out.

Not doing so resulted in understatement of capital WIP, understatement of reserves and surplus by Rs. 3.23 crore.

10. The management replied to the preliminary enquiry raised by the Government auditor as under:

The company has charged off to the statement of profit and loss, certain expenses which are of corporate nature, such as, formation expenses, share issue expenses, audit fees, filling fee, directors’ sitting fees etc. in the pre-operative period based on the applicable Accounting Standards and various opinions furnished by the Expert Advisory Committee of the Institute of Chartered Accountants of India. The details of such expenses charged off year-wise are given in Part-D of Annexure-1. After the withdrawal of the Guidance Note on Treatment of Expenditure During Construction Period by the Institute of Chartered Accountants of India and the introduction of AS 26, the concept of accumulation of general overhead expenses which are not related directly/indirectly to the construction under the head ‘deferred revenue expenditure’ for charging off to the statement of profit and loss after the commencement of commercial production is no longer a practice recognised under Accounting Standards. As such, these expenses of general overhead in nature are charged off to the statement of profit and loss even in the pre-operative period. This practice of accounting is in line with the provisions of AS 10 and AS 26.

The company has been consistently following this practice since its inception and accordingly, a sum of Rs 3.27 crore is appearing as a negative balance under the head ‘Reserves and Surplus’ in the balance sheet as on March 31, 2014.

The accounts of the company have been prepared and presented as per the applicable Accounting Standards notified by the Central Government giving due regard to various opinions/clarifications furnished by the Expert Advisory Committee of the Institute of Chartered Accountants of India (refer Query No. 25 of Volume 32, Query No. 1.25 of Volume 14, Query No. 8 of Volume 30 and Query No. 29 of Volume 29).
Since the preparation of accounts of the company and presentation thereof are compliant to the standards, there is no understatement of capital work in progress and ‘Reserves & Surplus’ as observed by the audit.

11. Subsequently, in supersession of the preliminary enquiry, the Government auditor made the following observations:

1. Capital Work in Progress Rs. 469.68 crore.

a. The above is overstated by Rs. 32.89 crore on account of inclusion of preoperative expenses pending allocation. As per paragraph 56 of Accounting Standards (AS) 26 Intangible Assets, the preoperative costs are to be charged off in the year of incurrence as this expenditure is incurred to provide future economic benefits to the enterprise, but no intangible asset or other asset is acquired or created. This has resulted in understatement of expenditure during the current year by Rs. 11.51 crore, prior period expenditure by Rs. 21.38 crore and cumulative loss by Rs. 32.89 crore. This has also resulted in non-adherence to the provisions of Accounting Standard (AS) 26, Intangible Assets.

b. During the period 2010-11 to 2013-14, the company has accounted the interest earned from unutilized /surplus funds and other miscellaneous receipts amounting to Rs. 24.29 crore (for the year 2013-14) as capital receipts as per the accounting policy 3 of the company on income during construction / pre-production period, “interest / dividend earned on investment of funds not immediately required and other miscellaneous receipts during the construction /pre-production period are treated as capital receipts and taken to reduce the pre-operative expenses to arrive at the net expenses to be capitalised”.

However, Audit is of the opinion that income from unutilised/surplus funds is an income from investments and is to be credited to statement of profit and loss as ‘Other income’. Adjusting the same to capital WIP is incorrect as the interest income is not earned from fixed assets. Therefore, the accounting policy needs suitable modification.
The above accounting treatment made by the company has resulted in understatement of capital WIP by Rs. 69.88 crore, current year income by Rs. 24.32 crore and prior period income by Rs. 45.56 crore.

The net impact on account of provisional comments (1) and (2) would result in tax liability of Rs. 12.57 crore and cumulative profit of Rs. 24.42 crore.

12. The management reply to the observations of the Government auditors is given below:

a. The company has been incurring various expenses relating to the implementation of the project including administrative and general expenses which are necessary for acquisition and construction of the assets and for bringing those assets to their working condition for intended use. Expenses which are directly related to construction / acquisition of fixed assets and administrative and general overhead expenses which are incidental to construction / acquisition of fixed assets net of income such as interest and miscellaneous receipts have been capitalised and grouped under ‘Pre-operative expenses related to construction’ while those which are not specifically related to construction and are mostly of general and corporate nature, such as, company formation expenses for bringing the company as a corporate/ legal entity, share issue expenses, audit fees, director’s sitting fees etc. have been grouped under ‘pre-operative expenses not specifically related to construction’ and charged off to the statement of profit and loss in the year of incurrence. The above accounting treatments are in compliance with the provisions of applicable Accounting Standards namely AS 10, AS 16 and AS 26 (to the extent applicable), as notified by the Central Government and consistent with the opinions rendered by the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) vide query no. 34, query no. 35 and query no. 36 of Volume 29, query no. 8 of Volume 30 and query no. 25 of Volume 32. Accordingly, financial statements showing Rs. 469.68 crore under the head capital work in progress includes Rs. 32.89 crore as pre-operative expenses pending allocation of which Rs. 11.51 crore pertains to the current year. As such,
there is no understatement of the expenditure during the current year and / or in the previous years as also cumulative loss as observed by the audit. Similarly, the accounting treatments given as above do not amount to non-adherence to the provisions of applicable Accounting Standards.

The observations made by the Government audit with reference to Accounting Standard (AS) 26 are relating to intangible assets only which are not relevant in the extant case as the company is engaged in the construction and acquisition of fixed assets for the project which are tangible and future economic benefits will flow to the organisation on implementation of project. Therefore, applicable Accounting Standard for treatment of expenditure during construction period should be Accounting Standard (AS) 10 relating to fixed assets. Paragraph 56(a) of AS 26, inter alia, provides that expenditure on start-up activities which is not included in the cost of fixed asset under AS 10 is only to be recognised as an expense when it is incurred.

In this regard, reference is drawn to paragraphs 9.1, 9.2, 9.3, 9.4 and 10.1 of AS 10 which are applicable to treatment of expenditure during construction period including any internal profits/ income relating to acquisition and construction of fixed assets. Similarly, Accounting Standard (AS) 16 is applied for capitalisation of borrowing cost relating to acquisition and construction of fixed assets.

Thus, from a wholesome reading of above paragraphs of AS 10, it would be clear that expenditures which are directly related or incidental to the construction and acquisition of fixed assets are only to be capitalized. Start-up/preliminary and pre-operative expenditures, such as company formation expenses, expenses on advertisement and promotional activities etc. are to be charged off to the statement of profit and loss in the year of incurrence as provided in paragraph 56 of AS 26. Other expenditure such as share issue expenses, borrowing costs etc. which are of specialised nature and are not covered by AS 26 are to be dealt by specific accounting standards, if any. For example, borrowing cost relating to construction of fixed assets is dealt with under AS 16. Audit fees, filing fees, director’s sitting fees and share
issue expenses etc. which are purely general, corporate and statutory in nature are normally charged off to the statement of profit and loss in the year of incurrence as these are not attributable specifically to any fixed asset. Accounting treatment given by the company consistently to the expenditure incurred during the construction period in the financial statements is strictly in compliance with the provisions of the above applicable accounting standards.

b. The company has earned interest on investment of funds out of share capital monies held for project, interest on mobilisation advance and other miscellaneous receipts which are inextricably linked to the construction and acquisition of fixed assets and has a direct nexus with the project. As such, these incomes during the construction period are necessarily to be capitalised. Due to its direct nexus with the construction and acquisition of fixed assets, such incomes are to be applied to the pre-operative expenditure to arrive at the net cost to be capitalised. Therefore, the accounting treatment accorded to the interest and other income during construction period is in compliance to paragraphs 9.1, 9.2, 9.3, 9.4 and 10.1 of AS10.

The view taken by the management on the treatment of income earned during the construction period is further corroborated by the favourable observations made by various judiciaries in the cases cited below:

a. Karnal Co-Operative Sugar Mills Limited vs CIT (SC)
b. CIT vs. Bokaro Steel Ltd (SC)
c. CIT vs. Karnal Co-operative Sugar Mills Limited (SC)
d. CIT vs. Karnataka Power Corporation (SC)
e. Indian Oil Panipat Power Consortium Limited Vs ITO (HC)
f. NTPC SAIL Power Company Private Limited Vs CIT. (HC)
g. CIT Vs VGR Foundations (HC)

In view of the above, accounting treatment accorded by the company is not resulting in understatement of capital WIP by Rs. 69.88 crore, current year income by Rs. 24.32 crore and prior period income by Rs. 45.56 crore as observed by the audit.
As regards tax liability, if any, on interest income during construction period, the company has preferred an appeal before CIT (Appeal) against the order of assessing officer taxing such income. Pending outcome of the appeal, the company has not recognised the tax demand as liability and consistent with its earlier practices, tax paid by the company is shown as advance tax. The explanations being adequately disclosed in other notes to financial statements no. 16(iii)(a)&(b), there is no tax liability of Rs. 12.57 crore as yet.

It may be reasonable to appreciate that income alone during the construction period cannot be taxed under the head other income in isolation by disallowing the expenditure only to be reduced from reserves and surplus. Therefore, both income and expenditure during construction period which are directly related and/or incidental to construction and acquisition of fixed assets in a project are to be reasonably capitalised as provided in paragraphs 9.1, 9.2, 9.3, 9.4 and 10.1 of AS 10.

As such, there is no understatement of cumulative profit of Rs. 24.42 crore as observed by the audit.

The accounting policies and practices as followed by the company consistently are compliant to applicable accounting standards and read with explanatory notes, the financial statements reflect a true, reasonable and fair view of the accounts and the state of affairs of the company.

13. The querist has stated that the statutory auditor of the company appointed by the Comptroller and Auditor General of India has concurred on the above reply. Finding no consensus, the observation was however dropped by the Government auditor (C&AG) on the assurance of the management that the issues shall be referred to the Expert Advisory Committee of the ICAI for its expert opinion.

B. Query

14. Based on the facts and circumstances of the case and having regard to the fact that the company is implementing a greenfield project from scratch, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
a. Whether the accounting treatment followed consistently by the company of capitalising administrative and general expenses along with specific expenses as detailed in part - A and part - B of the Annexure -1 is correct and in line with applicable accounting standards. If not, then what should be the accounting treatment for such expenses?

b. Whether it would be in order to capitalise expenses which are purely general and corporate in nature such as auditors’ fee, directors’ sitting fees etc. incurred during the construction period in the light of the fact that, the company’s only business being construction of the project.

c. Whether capitalisation of interest and other income during the construction period being incidental and inextricably linked to the construction is in order and in accordance with applicable accounting standards and Guidance Note issued by the ICAI. If not, then what should be the accounting treatment for such income?

C. Points considered by the Committee

15. The Committee notes that the basic issues raised in the query relate to accounting for various pre-operative expenses incurred before commencement of operations and during construction of the project, and accounting for interest income earned on surplus equity funds, interest on mobilization advance and other miscellaneous income earned before and during construction period. The Committee has, therefore, considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, disclosure of advance tax in the financial statements, etc. Further, the Committee has expressed its opinion purely from accounting perspective and not from tax perspective or from the perspective of legal interpretation of various judgments of High Court/Supreme Court, as referred to by the querist. The Committee also wishes to point out that as the exact nature and details of various expenses as listed by the querist in Annexure 1 are not available, the Committee’s opinion contained hereinafter is based on the general principles to be followed while accounting for such expenses.
16. At the outset, the Committee wishes to point out that various expenses are incurred during construction/pre-operative period before commencement of operations. However, it is not necessary that all expenses incurred during construction are eligible to be capitalised to the project/asset being constructed. The capitalisation of an item of cost to a fixed asset/project depends upon the nature of such expenses in relation to the construction/acquisition activity in the context of requirements in this regard laid down in the applicable accounting standards. The Committee notes from the Facts of the Case that the company in the extant case has incurred various pre-operative expenses before commencement of operations which can be broadly categorised into preliminary and pre-operative expenses on formation/incorporation of the company and other pre-operative and general and administrative expenses incurred during acquisition/construction of various assets/project (paper mill project) for commencement of its operations. In this context, the Committee notes the following paragraphs from AS 10 and AS 26, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

**AS 10**

"9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

(i) site preparation;
(ii) initial delivery and handling costs;
(iii) installation cost, such as special foundations for plant; and
(iv) professional fees, for example fees of architects and engineers.

..."

"9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the
Compendium of Opinions — Vol. XXXV

acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset."

"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. ..."

"10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs."

AS 26

"56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);

(b) expenditure on training activities;

(c) expenditure on advertising and promotional activities; and

(d) expenditure on relocating or re-organising part or all of an enterprise."

The Committee notes from the above that as per paragraph 56 of AS 26, start-up costs that relate to the costs of starting up an activity, such as,
preliminary expenses incurred in establishing an entity, expenditure to open a new facility or business and expenditure for commencing new operations should be expensed unless such expenditure can be included as an element of cost of a fixed asset. Further, the Committee notes from the above-reproduced paragraphs of AS 10 that the basic principle to be applied while capitalising an item of cost to a fixed asset/project under construction is that it should be directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition for its intended use. Further, as per the principles of AS 10, administration and general overhead expenses should not be included in the cost of a fixed asset/project unless these are specifically attributable to the construction/acquisition of a fixed asset/project or for bringing it to its working condition.

**Preliminary and pre-operative expenses on formation/incorporation of the company**

17. From the above discussion, the Committee is of the view that incorporation expenses or expenses incurred on incorporation or formation of a company to bring it into legal existence, such as, legal costs in drafting the memorandum and articles of association, fees for registration of the company, cost of printing of the memorandum and articles of association and statutory books of the company, etc. cannot be considered to be attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition for its intended use. Therefore, these expenses cannot be capitalised and accordingly should be expensed by way of a charge to the statement of profit and loss in the period in which these are incurred. In this regard, the Committee wishes to point out that the above-reproduced paragraph 9.3 of AS 10 refers to those start-up costs which are incurred on the start-up and commissioning of a *project* before the commencement of commercial production, such as, expenditure on test runs, etc., and not on incorporation of the enterprise. The Committee is further of the view that the auditors fee incurred in connection with the audit of the financial statements of the company and directors’ sitting fee cannot also be considered as directly attributable to the construction of the project/fixed asset even though the only activity of the company in that period relates to construction activity and, therefore, these cannot also be included as part of the cost of a fixed asset/project. With regard to accounting for share issue expenses, the Committee notes that AS 26 does not deal with such expenses. Accordingly, the Committee notes the definition of the term ‘asset’ as provided by the Framework for the Preparation and Presentation
of Financial Statements, issued by the ICAI, which states that, “an asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.” The Committee notes that share issue expenses do not meet the definition of the term ‘asset’ as no resource controlled by the company comes into existence out of the share issue expenses and, therefore, it cannot be recognised as an asset. Accordingly, the Committee is of the view that it would be appropriate to charge such expenses to the statement of profit and loss. In this regard, the Committee also wishes to point out that, to the extent permitted under the requirements of section 52 (2) of the Companies Act, 2013, the above preliminary expenses can also be adjusted against the securities premium account.

Other pre-operative expenses incurred during acquisition/construction of various assets/project

18. Further, with regard to other pre-operative expenses incurred during the acquisition/construction phase other than finance or interest costs incurred on long-term bank finance, the Committee is of the view that the accounting treatment of such expenses would depend upon whether or not such expenses are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition for its intended use, as discussed above. If the expenses incurred are directly attributable to construction/acquisition, such as, site preparation and installation costs, these can be capitalised with the cost of the concerned fixed asset(s)/project(s). However, if the expenses are not attributable to construction/acquisition, as aforesaid, these should be expensed by way of a charge to the statement of profit and loss. The Committee is further of the view that recruitment expenses, advertising and publicity expenses, foundation stone laying expenses, meeting and conference expenses, printing and stationery, newspaper, books, periodicals, subscription and membership expenses, security and other facility management services etc. are not ordinarily directly attributable to construction/acquisition and, therefore, are charged to the statement of profit and loss unless it can be demonstrated that these are directly attributable to construction as aforementioned. Since the facts of the query do not contain sufficient relevant details to establish whether expenses listed in Annexure 1 are directly attributable to construction/acquisition, the Committee has not dealt specifically with the individual expenses. Accordingly, in the extant case, the company should examine various expenses as listed in Annexure 1 keeping in view the nature and
purpose of such expenses as to whether or not these are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition for its intended use so as to determine the accounting treatment of such expenses. For example, legal and professional charges listed in the Annexure -1 can be capitalised with the cost of the fixed asset/project only if these are directly attributable to construction of the project, such as, engineer’s fees for engineering services related to the project. However, if such charges are not in relation to the construction of the project, e.g., consultant’s fees related to formation of the company, such charges should be charged to the statement of profit and loss. Similarly, there are various other expenses, such as, employee benefits expenses, travelling and conveyance expenses, communication charges, rent, rates and taxes, insurance expenses, etc. which need to be examined keeping in view the nature and purpose of such expenses so as to determine the accounting treatment of such expenses. These expenses can be capitalized with the cost of a fixed asset/project only to the extent these are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition for its intended use.

19. With regard to interest cost incurred on long term bank finance, the Committee notes the following relevant accounting principles related to borrowing costs as provided under Accounting Standard (AS) 16, ‘Borrowing Costs’, notified under the Rules, as follows:

“3.2 A **qualifying asset** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.”

“6. **Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.”

“14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:
(a) **expenditure for the acquisition, construction or production of a qualifying asset is being incurred**;

(b) **borrowing costs are being incurred**; and

(c) **activities that are necessary to prepare the asset for its intended use or sale are in progress.**

From the above, the Committee notes that the borrowing costs can be capitalised as a part of the cost of a qualifying asset only when expenditure for the acquisition, construction or production of qualifying asset is being incurred and other conditions of paragraph 14 of AS 16, as reproduced above are fulfilled.

*Interest income earned on surplus funds and mobilisation advance and miscellaneous income*

20. With regard to issue raised relating to interest earned on fixed deposits made out of surplus funds, interest earned on mobilisation advance and other miscellaneous receipts during the construction phase, the Committee notes paragraphs 10 and 11 of AS 16, notified under the Rules as follows:

“10. **To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.**

11. The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred."

The Committee notes from paragraphs 10 and 11 of AS 16 above that borrowing cost to be capitalised is to be adjusted with the income earned from temporary investment of specific borrowed funds while the project is in the stage of construction. Thus, the income earned from temporary
investments of specific borrowed funds during the construction period can be set-off against the borrowing costs to be capitalised as per the principles of AS 16. However, the Committee notes that these paragraphs deal with the investment of specific borrowed funds and not investment made out of equity funds. In this regard, the Committee notes that as per the requirements of AS 10, notified under the Rules, only those items of costs which are directly attributable to bringing the fixed asset to its working condition can be included in the cost of the asset. The Committee is of the view that the same principles can also be extended in respect of an item of income arising during the acquisition/construction of a fixed asset/project. Thus, only those items of income arising from the activities would go on to reduce the fixed asset/project cost, that are directly attributable to the acquisition/construction of a fixed asset/project for bringing it to its working condition for its intended use. In the extant case, the Committee is of the view that interest earned on fixed deposits made out of equity funds is an income arising out of the company’s ancillary activities which are not necessary to bring the project/asset to its working condition for its intended use and therefore, these cannot be considered as directly attributable to the mill project. Accordingly, interest income earned on the deposits made out of equity funds cannot be adjusted against the cost of the asset/project and therefore, should be recognised in the statement of profit and loss.

21. With regard to miscellaneous income earned during the construction period, the Committee is of the view that it should be examined as to whether such income is arising from activities that are directly attributable to the acquisition/construction of a fixed asset/project for bringing it to its working condition for its intended use. In case it is so, the income should be reduced from the cost of activity generating such miscellaneous income, which is to be included in the cost of the fixed asset.

22. As far as interest earned on mobilisation advance is concerned, the Committee notes that in the extant case, the purpose of mobilisation advance to the contractors is to have a quick start-up of the project. The Committee is of the view that since such advance is incidental to construction activity of the mill project and is an integral part of the contract with contractors, interest earned thereon can be considered to be arising from activities that are directly attributable to the acquisition/construction of a fixed asset/project for bringing it to its working condition for its intended use. Accordingly, interest earned on mobilisation advance in the extant case can be adjusted against the cost of the relevant fixed asset/project. Further, since such
interest would reduce the payment to be made to the contractor (as it would be recovered from the running account bill), it should be reduced from the cost of the asset/project concerned.

D. Opinion

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

a. The accounting treatment followed consistently by the company of capitalising administrative and general expenses along with specific expenses as detailed in part - A and part - B of the Annexure -1 would be correct and in line with applicable accounting standards, if these are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition for its intended use, as discussed in paragraphs 16-18 above. In case these expenses are not directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition for its intended use, these should be expensed by way of a charge to the statement of profit and loss.

b. The incorporation expenses or expenses incurred for formation of a company to bring it into legal existence, auditors fee, director sitting fees etc. cannot be considered as directly attributable to the construction of the project/fixed asset even though these are incurred during construction period and the company’s only business being construction of the project. Therefore, these cannot also be included as part of the cost of a fixed asset or project.

c. The interest income earned from temporary investments of specific borrowed funds during the construction period can be set-off against the borrowing costs to be capitalised as per the principles of AS 16. However, interest earned on fixed deposits made out of equity funds is an income arising out of the company’s ancillary activities which are not necessary to bring the fixed asset/project to its working condition for its intended use and therefore, these cannot be considered as directly attributable to the mill project. Accordingly, the same cannot be adjusted against the cost of the asset/project and should be recognised in the statement of profit and loss. Since mobilisation advance is incidental to construction
activity of the mill project and is an integral part of the contract, interest earned thereon can be considered to be arising from activities that are directly attributable to the acquisition/ construction of a fixed asset/project for bringing it to its working condition for its intended use. Accordingly, interest earned on mobilisation advance in the extant case can be adjusted against the cost of the relevant fixed asset/project, as discussed in paragraph 22 above. Other miscellaneous income earned during the construction period can be adjusted against the cost of the relevant fixed asset/project, only if such income is arising from activities that are directly attributable to the acquisition/ construction of the asset/project for bringing it to its working condition for its intended use, as discussed in paragraph 21 above. Further, such income should be reduced from the cost of related activity generating such miscellaneous income, which is to be included in the cost of the fixed asset.

Annexure 1

<table>
<thead>
<tr>
<th>Details of Expenditure during construction period &amp; its accounting treatment:</th>
<th>Amount in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Pre-operative expenses pending allocation</td>
<td></td>
</tr>
<tr>
<td>Project Consultant’s fees</td>
<td>34,097,139</td>
</tr>
<tr>
<td>Preparation of DPR Paper mill fees</td>
<td>5,233,996</td>
</tr>
<tr>
<td>Preparation of DPR Water Supply Fees</td>
<td>981,000</td>
</tr>
<tr>
<td>Project Building Plan Sanction fees</td>
<td>8,317,586</td>
</tr>
<tr>
<td>Project Insurance</td>
<td>-</td>
</tr>
<tr>
<td>Site Audit Fees</td>
<td>280,804</td>
</tr>
<tr>
<td>Site Development Expenses</td>
<td>-</td>
</tr>
</tbody>
</table>
### Technical Advisors - Remuneration & Travelling Expenses

<table>
<thead>
<tr>
<th></th>
<th>2010-11</th>
<th>2011-12</th>
<th>2012-13</th>
<th>2013-14</th>
<th>Amount in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical Advisors - Remuneration &amp; Travelling Exp.</td>
<td>1,871,112</td>
<td>1,068,620</td>
<td>491,800</td>
<td>-</td>
<td>3,431,532</td>
</tr>
<tr>
<td>Topographical Survey Fees</td>
<td>110,195</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>110,195</td>
</tr>
<tr>
<td>Geo-Technical Survey Fees</td>
<td>416,141</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>416,141</td>
</tr>
<tr>
<td>Consent Fee-KSPCB</td>
<td>400,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>400,000</td>
</tr>
<tr>
<td>Fee for Power Connection</td>
<td>31,134</td>
<td>-</td>
<td>50,000</td>
<td>-</td>
<td>81,134</td>
</tr>
<tr>
<td>Statutory Clearance fee - Karnataka Udyog Mitra</td>
<td>300,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>300,000</td>
</tr>
<tr>
<td>Foundation Stone laying expenses</td>
<td>2,000,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>Sub Total (A)</strong></td>
<td>54,039,107</td>
<td>12,045,312</td>
<td>23,516,044</td>
<td>34,738,350</td>
<td>124,338,813</td>
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</table>

### B. Other Administrative and General Expenses related to Construction:

<table>
<thead>
<tr>
<th></th>
<th>2010-11</th>
<th>2011-12</th>
<th>2012-13</th>
<th>2013-14</th>
<th>Amount in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Benefits Expenses</td>
<td>8,817,177</td>
<td>16,710,320</td>
<td>24,794,450</td>
<td>37,817,786</td>
<td>88,139,733</td>
</tr>
<tr>
<td>Finance Cost</td>
<td>5,726</td>
<td>10,218</td>
<td>5,669,440</td>
<td>5,364,978</td>
<td>11,050,362</td>
</tr>
<tr>
<td>Depreciation and Amortization Expenses</td>
<td>444,954</td>
<td>5,567,542</td>
<td>6,041,785</td>
<td>6,442,978</td>
<td>18,497,259</td>
</tr>
</tbody>
</table>

**Other Administrative & General Expenses:**

<table>
<thead>
<tr>
<th></th>
<th>2010-11</th>
<th>2011-12</th>
<th>2012-13</th>
<th>2013-14</th>
<th>Amount in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Travelling, halting &amp; conveyance expenses</td>
<td>4,933,036</td>
<td>1,891,336</td>
<td>3,628,960</td>
<td>8,249,094</td>
<td>18,702,426</td>
</tr>
<tr>
<td>Printing and stationary</td>
<td>143,522</td>
<td>495,087</td>
<td>558,947</td>
<td>904,997</td>
<td>2,102,553</td>
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<tr>
<td>Communication charges</td>
<td>90,589</td>
<td>443,297</td>
<td>594,635</td>
<td>665,285</td>
<td>1,793,806</td>
</tr>
<tr>
<td>Power, fuel, light and water</td>
<td>43,182</td>
<td>1,157,319</td>
<td>1,321,585</td>
<td>1,391,701</td>
<td>3,913,787</td>
</tr>
<tr>
<td>Rent, rates &amp; taxes</td>
<td>2,037,696</td>
<td>7,963,316</td>
<td>8,128,295</td>
<td>8,220,185</td>
<td>26,349,492</td>
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<tr>
<td>Legal &amp; professional charges</td>
<td>270,131</td>
<td>638,755</td>
<td>947,195</td>
<td>706,226</td>
<td>2,562,307</td>
</tr>
<tr>
<td>Advertisement &amp; publicity expenses</td>
<td>5,454,692</td>
<td>398,463</td>
<td>2,223,014</td>
<td>1,636,875</td>
<td>9,713,044</td>
</tr>
<tr>
<td>Repairs &amp; maintenance</td>
<td>-</td>
<td>947,275</td>
<td>1,396,148</td>
<td>2,914,583</td>
<td>5,258,006</td>
</tr>
<tr>
<td>Security &amp; other facility management services</td>
<td>-</td>
<td>2,002,009</td>
<td>2,925,220</td>
<td>3,398,516</td>
<td>8,325,745</td>
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<tr>
<td>Insurance expenses</td>
<td>-</td>
<td>9,708</td>
<td>124,878</td>
<td>125,934</td>
<td>260,520</td>
</tr>
<tr>
<td></td>
<td>2010-11</td>
<td>2011-12</td>
<td>2012-13</td>
<td>2013-14</td>
<td>Total</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>---------</td>
<td>---------</td>
<td>---------</td>
<td>---------</td>
<td>----------</td>
</tr>
<tr>
<td>Total Pre-operative expenses pending allocation (from above)</td>
<td>76,878,311</td>
<td>51,529,036</td>
<td>85,463,142</td>
<td>115,076,290</td>
<td>328,946,779</td>
</tr>
<tr>
<td>Add:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on Term Loan on acquisition &amp; construction of fixed assets.</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
<td>34,009,846</td>
</tr>
<tr>
<td>Less: Capital Receipts:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on Short Term Deposits</td>
<td>55,078,526</td>
<td>170,172,084</td>
<td>215,281,724</td>
<td>240,308,305</td>
<td>680,840,636</td>
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<tr>
<td>Interest on Mobilisation advance</td>
<td>-</td>
<td>6,740,994</td>
<td>6,146,287</td>
<td>2,571,530</td>
<td>15,458,811</td>
</tr>
<tr>
<td>Interest on Income Tax refund</td>
<td>-</td>
<td>-</td>
<td>1,864,395</td>
<td>-</td>
<td>1,864,395</td>
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<tr>
<td>Miscellaneous Receipts</td>
<td>25,556</td>
<td>17,745</td>
<td>320,211</td>
<td>360,927</td>
<td>724,439</td>
</tr>
<tr>
<td>Sub Total</td>
<td>55,104,081</td>
<td>176,930,823</td>
<td>223,612,617</td>
<td>243,240,762</td>
<td>698,888,281</td>
</tr>
<tr>
<td>Net pre-operative Expenses capitalised under the head CWIP</td>
<td>21,774,230</td>
<td>125,401,787</td>
<td>138,149,475</td>
<td>-94,154,626</td>
<td>-335,931,656</td>
</tr>
</tbody>
</table>
### Expenses not related to construction and charged off to P&L Statement:

<table>
<thead>
<tr>
<th>D.</th>
<th>2010-11</th>
<th>2011-12</th>
<th>2012-13</th>
<th>2013-14</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Company registration and incorporation expenses</td>
<td>2,50,07,020</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>2,50,07,020</td>
</tr>
<tr>
<td>2. Solicitor’s fees in connection with registration of company</td>
<td>7,50,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>7,50,000</td>
</tr>
<tr>
<td>3. Share issue expenses</td>
<td>20,00,000</td>
<td>-</td>
<td>40,00,000</td>
<td>-</td>
<td>60,00,000</td>
</tr>
<tr>
<td>4. Directors sitting fees</td>
<td>20,000</td>
<td>40,000</td>
<td>82,416</td>
<td>89,888</td>
<td>2,32,304</td>
</tr>
<tr>
<td>5. Statutory auditors fees</td>
<td>27,575</td>
<td>56,180</td>
<td>1,12,360</td>
<td>1,23,596</td>
<td>3,19,711</td>
</tr>
<tr>
<td>6. Internal auditors fees</td>
<td>-</td>
<td>67,416</td>
<td>89,888</td>
<td>1,12,360</td>
<td>2,69,664</td>
</tr>
<tr>
<td>7. Others</td>
<td>1,33,332</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1,33,332</td>
</tr>
<tr>
<td>Total expenses charged off to P&amp;L statement</td>
<td>2,79,37,927</td>
<td>1,63,596</td>
<td>42,84,664</td>
<td>3,25,844</td>
<td>3,27,12,031</td>
</tr>
</tbody>
</table>

### Query No. 6

**Subject:** Accounting treatment for amalgamation of wholly owned subsidiary.¹

**A. Facts of the Case**

1. A company is listed on the stock exchanges in India and is in the business of providing services. The company has finalised a scheme of arrangement to reorganise its group structure wherein three wholly owned subsidiaries, namely A Ltd., B Ltd. and C Ltd. (hereinafter also referred to as the amalgamating companies) will be amalgamated with the company. The scheme requires fair valuation of all assets and liabilities of the amalgamating companies. The fair value of assets will be assessed by an independent valuer and the fair valuation report will be used as a basis to determine value at which the assets and liabilities will be recognised in the books of amalgamated company. Brief nature of business operations of amalgamating companies is as follows:

   **A Limited:** - Company A is engaged in the business of making investment into the shares and securities of its group companies /

¹ Opinion finalised by the Committee on 3.6.2015.
body corporates.

**B Limited**: Company B was set up to be engaged in the business of online services. Currently, there are no business operations in this company, however, it intends to carry out the business as per the object clause of the company.

**C Limited**: Company C is presently engaged in the business of providing services to corporate customers.

2. The querist has stated that as per the Scheme:

   (1) Accounting for the amalgamation and treatment of goodwill or reserves, if any, in the books of amalgamated company shall be in accordance with the provisions of the Accounting Standard (AS) 14, ‘Accounting for Amalgamations’ and Generally Accepted Accounting Principles (GAAPs) in India.

   (2) With effect from the Appointed Date, amalgamated company shall record all the assets and liabilities, including any intangible assets, pertaining to the amalgamating companies transferred to and vested in amalgamated company pursuant to the Scheme, at their fair value.

   (3) The inter-company balances between amalgamating companies and amalgamated company, if any, including any shares held by amalgamated company in amalgamating companies shall stand cancelled.

   (4) An amount corresponding to the value of net assets transferred to amalgamated company, after making adjustment as mentioned in 3 above, shall be credited to ‘Capital Reserve Account’ (in case of excess of assets over liabilities) or debited to ‘Goodwill Account’ (in case of excess of liabilities over assets), as the case may be, in the financial statements of amalgamated company.

3. **Nature of amalgamation as per AS 14**

   The querist has further stated that in Indian GAAPs, accounting for amalgamations of companies is governed by a specific standard, i.e., AS 14, notified under the Companies (Accounting Standards) Rules, 2006. As per paragraph 7 of the AS 14, there are two methods of accounting for
amalgamations: (a) the pooling of interests method; and (b) the purchase method. As per paragraph 8 of AS 14, the pooling of interests method can be applied only where amalgamation meets the criteria referred to in paragraph 3(e) for an amalgamation in the nature of merger. In this regard, paragraph 5 of AS 14, inter alia, states that “An amalgamation is classified as an ‘amalgamation in the nature of merger’ when all the conditions listed in paragraph 3(e) are satisfied”. Further, as per paragraph 3(f) of AS 14, “Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified in sub-paragraph (e) above.”

4. An assessment of the Scheme vis-a-vis the conditions in paragraph 3(e) for classifying the amalgamation as ‘in the nature of merger’ has been made by the querist as under:

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company:

This condition is satisfied – As per the Scheme, all the assets and liabilities of all the transferor companies shall become the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation:

This condition is satisfied since the transferor companies are 100% owned by the transferee.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares:

The transferor is a wholly owned subsidiary. Hence this clause is
According to the querist, since all the conditions of paragraph 3(e) are not met, the amalgamation qualifies as an amalgamation in the nature of purchase.

5. The querist has further stated that at a group level, there is no change of control. However, this does not necessarily imply that the transferred net assets should be recognised at carrying value as per the books of the transferor company. Indian GAAPs give primacy to the legal entity concept. At a legal entity level, there has been a transfer of net assets. Even internationally, there is no specific enunciation regarding the accounting of the transferred assets and liabilities in case of a common control business combination. Where the transaction qualifies as a business combination within the meaning of International Financial Reporting Standard (IFRS) 3, ‘Business Combinations’, issued by the International Accounting Standards Board and involves entities under common control, by practice, the following accounting treatment applies:

- In consolidated financial statements, the acquirer in a business combination under common control applies either book value basis or IFRS 3 (fair value).
- In its separate financial statements, the acquirer uses one of the following approaches:
  - Book value accounting
Compendium of Opinions — Vol. XXXV

— Fair value accounting
— Exchange amount accounting (however, this basis is not appropriate in transactions in which no consideration, or nominal consideration, has been transferred).

Thus, the practice is diverse with companies using fair value as well as book value for recognition of assets and liabilities transferred.

6. In this regard, reference has also been made by the querist to the following discussion in AS 14:

“5. An amalgamation is classified as an ‘amalgamation in the nature of merger’ when all the conditions listed in paragraph 3(e) are satisfied. There are, however, differing views regarding the nature of any further conditions that may apply. Some believe that, in addition to an exchange of equity shares, it is necessary that the shareholders of the transferor company obtain a substantial share in the transferee company even to the extent that it should not be possible to identify any one party as dominant therein. This belief is based in part on the view that the exchange of control of one company for an insignificant share in a larger company does not amount to a mutual sharing of risks and benefits.

6. Others believe that the substance of an amalgamation in the nature of merger is evidenced by meeting certain criteria regarding the relationship of the parties, such as the former independence of the amalgamating companies, the manner of their amalgamation, the absence of planned transactions that would undermine the effect of the amalgamation, and the continuing participation by the management of the transferor company in the management of the transferee company after the amalgamation.”

(Emphasis supplied by the querist.)

As per the querist, as is evident from the above, the standard setter had considered whether additional conditions (such as, no transfer of control, the absence of planned transactions that would undermine the effect of the amalgamation, the continuing participation by the management of the transferor company in the management of the transferee company after the amalgamation) are required for classifying an amalgamation to be in the nature of merger. However, no such conditions have been prescribed in
paragraph 3(e) which defines amalgamation in the nature of merger and which requires only the 5 specified criteria therein to be met. Accordingly, it would not be appropriate to apply additional considerations other than those specified in paragraph 3(e) for determining the nature of amalgamation. Thus, since all of the five conditions are not met, the additional considerations would not be relevant and the amalgamation cannot be classified as an amalgamation in the nature of merger.

7. The querist has also stated that the transaction should be viewed as per the currently applicable notified standards in India, i.e., AS 14. This would be so, even if the relevant Ind-AS (which are yet to be notified) states otherwise. AS 14 is a notified Standard and it has to be followed. AS 14 clearly lays down that if any one or more of the five conditions listed in paragraph 3(e) is not satisfied, “an amalgamation should be considered to be an amalgamation in the nature of purchase”. In case the amalgamation is classified to be in the nature of merger to be accounted for using pooling of interest method, it would be in non-compliance of AS 14 since the conditions prescribed by the Standard for amalgamation in the nature of merger are not met. AS 14 does not preclude the use of fair value in an amalgamation within the group; the value at which assets and liabilities are being incorporated is relevant only for assessing the classification of amalgamation.

8. The matter also needs to be considered from the perspective of the objectives that the Scheme seeks to achieve, i.e.,

- Prioritize resource allocation amongst businesses
- Realign business operations

The reorganisation will remove inefficiencies and combine similar business interest into one corporate entity, resulting in economies of scale, operational synergies, simplification, efficient administration, improved allocation of capital, etc.

B. Query

9. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether application of purchase method under the Scheme of arrangement in the present case is in compliance with AS 14 and Generally Accepted Accounting Principles in India.

C. Points considered by the Committee
10. The Committee notes that the basic issue raised by the querist relates to whether the ‘purchase method’, as per the principles of AS 14 can be applied in the extant case or not. Accordingly, the Committee has considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for inter-company balances between amalgamating companies and amalgamated company, if any, including the shares held by amalgamated company in amalgamating companies and consequent adjustment to reserves or goodwill in the books of the amalgamated company pursuant to amalgamation, recording of assets and liabilities of the amalgamating companies at fair value in the books of amalgamated company, etc. Further, the opinion expressed hereinafter is purely from accounting perspective and not from legal perspective involving interpretation of various legal enactments.

11. With regard to the issue of application of method as per AS 14 in the extant case, viz., the pooling of interests method or the purchase method, the Committee is of the view that the application of any method of amalgamation depends on the type of amalgamation, viz., whether it is amalgamation in the nature of merger or it is in the nature of purchase. In this regard, the Committee notes paragraphs 3(e) and 3(f) of AS 14, notified under the Companies (Accounting Standards), Rules, 2006 as follows:

"3(e) Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee
company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

3 (f) *Amalgamation in the nature of purchase* is an amalgamation which does not satisfy any one or more of the conditions specified in sub-paragraph (e) above.*

The Committee notes from the above that as per paragraph 3(f) of AS 14, an amalgamation is an ‘amalgamation in the nature of purchase’ when all or any of the conditions listed in paragraph 3 (e) above are not satisfied. The Committee notes from the Facts of the Case that as per the Scheme of amalgamation in the extant case, “amalgamated company shall record all the assets and liabilities pertaining to amalgamating companies transferred to and vested in amalgamated company pursuant to the Scheme at their fair value”. Thus, condition (v) of paragraph 3(e) of AS 14 relating to “no adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies” is not satisfied. Accordingly, the Committee is of the view that in the extant case, the definition of ‘amalgamation in the nature of purchase’ as per paragraph 3 (f) of AS 14 reproduced above is met, and therefore, the company should apply ‘purchase method’ in the extant case as per the requirements of AS 14.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the application of purchase method in the extant case would be in compliance with AS 14 and GAAPs in India, as discussed in paragraph 11 above.
Query No. 7

Subject: Requirement of preparation of complete/condensed set of financial statements for interim financial reporting.

A. Facts of the Case

1. A Government company (hereinafter referred to as the ‘company’) incorporated under the Companies Act, 1956, is a leading turnkey construction company having widespread operations in several parts of India and other countries. The company got listed in Mumbai and Delhi Stock Exchanges in the year 1992 when the Government of India disinvested 0.27% of its shares in the company.

2. The querist has stated that the company got delisted from Mumbai and Delhi Stock Exchanges w.e.f. 03.11.2011 and 15.04.2012 respectively but two investors who are Government of India institutions continued with their holding which constitutes 0.27% of total share capital of the company.

3. Even after delisting of shares from the stock exchanges, the company continued to prepare condensed statement of profit and loss on quarterly basis and putting up to Audit Committee and the Board. The company is also getting its quarterly results limited reviewed by the central statutory auditors as was being done when the company was listed. However, the limited review report by the auditors is used for internal purposes only and is not put in public domain.

4. The querist has further stated that recently, statutory auditors of the company gave their observations that the company is not complying with Accounting Standard (AS) 25, ‘Interim Financial Reporting’. They were of the view that the company should prepare complete set of financial statements, i.e., condensed balance sheet, condensed statement of profit and loss, condensed cash flow statement and selected explanatory notes. The querist has referred to the following provisions of AS 25:

"Objective

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in a complete or condensed financial statements for

1Opinion finalised by the Committee on 3.6.2015.
an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors and others to understand an enterprise’s capacity to generate earnings and cash flows, its financial condition and liquidity.

Scope

1. **This Standard does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard.**

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

3. The requirements related to cash flow statement, complete or condensed, contained in this Standard are applicable where an enterprise prepares and presents a cash flow statement for the purpose of its annual financial report.”

5. The company is of the view that it is not required to prepare complete or condensed set of financial statements for each quarter due to following reasons:

   (a) The objective of interim financial reporting is to improve the ability of investors, creditors and others to understand an enterprise’s capacity to generate earnings and cash flows, its financial condition and liquidity. The interim financial reports being prepared by the company and getting them limited reviewed by the auditors are for internal purposes only and are not given to outside agencies like investors, creditors etc. Since the financial statements are not used for the objective of their preparation as laid down in the Standard, the company is not required to prepare all the components of interim financial reports. As a matter of precaution, these reports and limited review reports can be marked as ‘for internal purposes only’. The querist has provided the format
of interim financial report being prepared by the company for the perusal of the Committee.

(b) Shares of the company are no longer listed on stock exchanges, hence, there is no listing agreement requirement to prepare quarterly results.

(c) The company has no obligation by any statute to prepare interim financial statements.

(d) As per listing requirement of SEBI, statement of assets and liabilities is required to be prepared by the companies only for the half year ending. Therefore, many listed companies are publishing their quarterly results for the quarter ending June and December without condensed balance sheet. Listed companies are also not preparing cash flow statement for any interim financial reporting.

B. Query

6. In the above background, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the company is required to prepare complete set of condensed financial statements for each quarter considering the fact that the company has no obligation by any statute to prepare quarterly results.

(ii) If it is required, what are the minimum components of interim financial reports?

(iii) Any additional disclosure, if required, in the existing reports being prepared by the company so that the reporting is in compliance with the Standard?

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to requirement of preparation by the company of complete or condensed set of financial statements for interim financial reporting and, if required, minimum components of interim financial reports and any additional disclosure requirements in the existing report being prepared by the company to make it in compliance with AS 25. 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, requirements to prepare interim financial statements under any statute, preparation of cash flow statement by listed companies for interim financial reporting, applicability of any other suitable reporting framework apart from the requirements of AS 25, etc. The Committee has presumed that the company, after delisting from stock exchanges, has no requirement to prepare interim financial report under any law and that by preparing only a condensed statement of profit and loss, the company is not claiming preparation of ‘interim financial report’ in compliance with the requirements of AS 25. Further, the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of the legal enactment, such as, SEBI guidelines etc.

8. The Committee notes paragraphs 1 to 3, 4.2, 6 and 9 of AS 25, notified under the Companies (Accounting Standards) Rules, 2006 and paragraph 4 of the Guidance Note on Applicability of AS 25 to Interim Financial Results, issued by the Institute of Chartered Accountants of India as follows:

AS 25

"Scope"

1. This Standard does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard.

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

3. The requirements related to cash flow statement, complete or condensed, contained in this Standard are applicable where an enterprise prepares and presents a cash flow statement for the purpose of its annual financial report."
“4.2 Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Statement) for an interim period.”

“Content of an Interim Financial Report

6. A complete set of financial statement normally includes:
   (a) balance sheet;
   (b) statement of profit and loss;
   (c) cash flow statement; and
   (d) notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.”

“MINIMUM COMPONENTS OF AN INTERIM FINANCIAL REPORT

9. An interim financial report should include, at a minimum, the following components:
   (a) condensed balance sheet;
   (b) condensed statement of profit and loss;
   (c) condensed cash flow statement; and
   (d) selected explanatory notes.”

Guidance Note on Applicability of AS 25 to Interim Financial Results

“4. The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an ‘interim financial report’ as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of ‘interim financial report’ as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not
meet the definition of ‘interim financial report’ as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.”

From the wholesome reading of the above requirements, the Committee notes that AS 25 does not mandate which enterprises should be required to present interim financial reports. However, if an enterprise is required or elects to prepare and present an interim financial report, as defined in the Standard, it should comply with the requirements of AS 25. In this regard, the Committee notes from the Facts of the Case that the company, after delisting of shares from the stock exchanges, is not required to prepare and present interim financial report. The company, however, has elected to prepare only the condensed statement of profit and loss. The Committee notes that, as per the requirements of the Standard, interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period. The Committee is of the view that only preparation of condensed statement of profit and loss cannot be considered as preparation of ‘interim financial report’ as per the requirements of AS 25. Therefore, the requirements of AS 25 to prepare either complete set of financial statements or a set of condensed financial statements for each quarter, as being contended by the statutory auditor, are not applicable to the company. The Committee further notes the Objective paragraph of AS 25 as reproduced by the querist in paragraph 4 above and is of the view that, primarily, the purpose of preparing interim financial report is to report or present an enterprise’s capacity to generate earnings and cash flows, its financial condition and liquidity to the investors, creditors and other users (external). However, the company in the extant case is not presenting the condensed statement of profit and loss to external users and is preparing the statement for internal purposes only. In this regard, the Committee also wishes to point out that it would be useful if the company includes a note alongwith the condensed statement of profit and loss stating that the statement should not be considered as an ‘interim financial report’ as per the requirements of AS 25 and further such a statement of profit and loss should not be referred to as ‘interim financial report’ or ‘interim financial statement’. It would also be useful if the condensed statement of profit and loss prepared by the company for internal purposes is marked as ‘for internal purposes only’, as being suggested by the querist in paragraph 5 above.
D. Opinion

9. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 6 above:

(i) No, the company is not required to prepare either complete set of financial statements or a set of condensed financial statements for each quarter as discussed in paragraph 8 above.

(ii) & (iii) In view of the (i) above, the answer to these does not arise.

Query No. 8

Subject: Method of depreciation as per requirements of the Companies Act, 2013.¹

A. Facts of the Case

1. The querist has stated that Schedule II to the Companies Act, 2013 defines the depreciable value and the useful life of the asset and by dividing the depreciable value of the asset with the useful life of the asset, the rate is calculated at which depreciation is to be charged on any depreciable asset and this appears to be straight line method. However, Accounting Standard (AS) 6, ‘Depreciation Accounting’², provides that the depreciation can be charged either on the basis of straight line method (SLM) or written down value (WDV) method. The Schedule II is not clear whether a company can apply the WDV method for charging depreciation.

2. The querist has further stated that the company (X) has two production units (A and B) located at different places. Till financial year 2013-14, Unit A was using the straight line method (SLM) for charging depreciation whereas Unit B was using the written down value method (WDV) for charging depreciation as per the specific rates provided in Schedule XIV to the erstwhile Companies Act, 1956.

¹ Opinion finalised by the Committee on 3.6.2015.
² The opinion should be read in the context of Accounting Standard (AS) 6, ‘Depreciation Accounting’, which has been withdrawn by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.
3. According to the querist, with the enactment of the Companies Act, 2013, Schedule II provides for the concept of useful life of the asset instead of specific depreciation rates as provided under Schedule XIV to the erstwhile Companies Act, 1956, for straight line method and written down value method.

B. Query

4. In the above background, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

   (i) Whether Schedule II of the Companies Act, 2013 prescribes only straight line method for charging depreciation or any other method for charging depreciation can also be used.

   (ii) Whether Unit A can continue to charge depreciation following straight line method and Unit B continue to charge depreciation following written down value method for charging depreciation for the year 2014-15 as per Schedule II to the Companies Act, 2013, or both units will have to adopt same method for charging depreciation.

C. Points considered by the Committee

5. The Committee notes from the Facts of the Case that the issues raised in the query relate to methods of charging depreciation as per the requirements of Schedule II and whether different method of depreciation can be adopted by the company for two units. 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, calculation of depreciation rate, determination of useful life of the assets, etc.

6. With regard to methods of depreciation, the Committee further notes the following provisions of Schedule II to the Companies Act, 2013 and Accounting Standard (AS) 6, ‘Depreciation Accounting’ notified under the Companies (Accounting Standards) Rules, 2006:

   *Schedule II*

   “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. The useful life of an asset is the period over which
an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity."

"Notes"

3. The following information shall also be disclosed in the accounts, namely:—

   (i) depreciation methods used; and

   (ii) the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule."

AS 6

"3.1 Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined."

"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."

"12. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straight line method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors, e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired."
“15. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is 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 is recalculated in accordance with the new method from the date of the asset coming into use. ...”

7. The Committee notes that section 123 of the Companies Act, 2013, requires that “depreciation shall be provided in accordance with the provisions of Schedule II” and, as compared to Schedule XIV to the Companies Act, 1956, Schedule II does not specify any method of depreciation but only provides the indicative useful life of the assets. Accordingly, the Committee notes that neither section 123 nor Schedule II of the Companies Act, 2013, specifically lay down the methods of depreciation. The Committee further notes that, although the methods of depreciation have not been specified, Schedule II requires depreciation methods used to be disclosed in financial statements. Thus, the Committee is of the view that any appropriate method of depreciation, such as, SLM, WDV and Unit of Production (UoP) can be used considering the useful life of the assets and other requirements of Schedule II to the Companies Act, 2013 and AS 6.

8. The Committee further notes from the requirements of Schedule II and AS 6 that the basic purpose of charging depreciation is to allocate depreciable amount of an asset over its useful life so as to reflect a true and fair view of the financial statements. The Committee notes that the Guidance Note on Accounting for Depreciation in Companies, issued by the Institute of Chartered Accountants of India, provides in paragraph 9 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”. Accordingly, the Committee is of the view that selection of most appropriate method of depreciation is a matter of judgement by the management considering various factors, such as, type of asset, the nature of the use of such asset and circumstances prevailing in the business, to allocate the depreciable amount of an asset over its useful life. Further, since depreciation is a measure of wearing out, consumption or other loss of value of a depreciable asset, the depreciation
method selected should reflect such wearing out, consumption or loss of value of asset over its useful life appropriately and adequately. As per AS 6, methods normally used are Straight Line Method (SLM)/Written Down Value Method (WDV). However, the selection of a method depends upon the facts and circumstances of the case and therefore, the company should select the most appropriate method based on various factors, as discussed above.

9. With regard to the issue as to whether different methods of depreciation can be adopted by the company for two units, the Committee notes the following requirements of the Guidance Note on Accounting for Depreciation in Companies, issued by the Institute of Chartered Accountants of India:

“Adoption of different methods for different types of assets

5. A company may adopt more than one method of depreciation. Thus, it is permissible to follow different methods for different types of assets provided the same methods are consistently adopted from year to year in accordance with Section 205(2). Also, units in different geographical locations can follow different methods of depreciation provided the same are consistently followed.”

From the above, the Committee is of the view that although the Guidance Note permits units in different geographical locations to follow different methods of depreciation, the requirements of the Guidance Note should be read along with the requirements of Schedule II and AS 6. Accordingly, the Committee is of the view that the method of depreciation selected for the units at two different locations can be different if the methods selected reflect differences in wearing out, consumption or other loss of value of a depreciable asset over its useful life considering the requirements of Schedule II and AS 6, as discussed in paragraph 8 above. If there is no difference in wearing out, consumption or other loss of value of an asset in different units at different geographical locations, the company cannot use different methods of depreciation for the asset.

D. Opinion

10. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 4 above:

(i) Apart from SLM, other methods of depreciation, such as, WDV can also be used considering the requirements of Schedule II to
the Companies Act, 2013 and AS 6, as mentioned in paragraph 7 above.

(ii) The company can follow different methods of depreciation for an asset in different units at different geographical locations only if the depreciation methods selected for such asset(s) reflect differences in the wearing out, consumption or other loss of value of such asset(s) over its useful life, as discussed in paragraphs 8 and 9 above.

Query No. 9

Subject: Accounting treatment in respect of foreign currency loans hedged by a composite cross currency interest rate swap contract and accounting therefor.¹

A. Facts of the Case

1. A company is a public limited company registered under the Companies Act, 1956. The entire equity of the company is held by the Government of India. The company is also recognised as a Public Financial Institution. The company was set up as a special purpose vehicle to provide long-term infrastructure finance as per ‘Scheme for financing viable infrastructure projects’. As per its mandate, the company provides infrastructure finance through direct lending, take out finance and refinancing in compliance with the Scheme.

2. As per the Office Memorandum of the Government of India dated 23rd April, 2007, the company was regulated directly by the Government of India under a ‘Sui-generis’ regulatory regime. Accordingly, an Oversight Committee was constituted by the Government of India. Consequent upon Union Cabinet approval on 13th October, 2011 to bring the company under regulatory oversight of the Reserve Bank of India by registering it as an Non-Banking

¹ Opinion finalised by the Committee on 3.6.2015.
Finance Company-Infrastructure Finance Company (NBFC-IFC), the company is required to register itself as an NBFC-IFC.

3. The company is engaged in the business of providing long-term financial assistance to infrastructure projects in the country. The paid-up equity capital of the company is Rs. 2000 crore. The company has raised long-term loans from the Life Insurance Corporation (LIC) of India, National Small Saving Fund (NSSF) and bonds listed in India and foreign currency loans from bilateral and multilateral institutions. Borrowings of the company are backed by sovereign guarantee. The company has also issued long-term infrastructure bonds under section 80CCF of the Income-tax Act, 1961.

4. The details of foreign currency borrowings of the company as on 30th September, 2011 have been provided by the querist. The company has raised resources by way of foreign currency loans from multilateral institutions, viz., Asian Development Bank (ADB), Kreditanstalt für Wiederaufbau (KFW) and the World Bank. In order to mitigate risk of losses due to changes in foreign exchange rate and floating rate of interest risk, the company undertakes hedging of loans by entering into cross currency (composite for principal repayments and coupon payments in line with loan underlying availed from multilateral and bilateral agencies) and interest rate swaps. The details of hedging transactions undertaken by the company have also been provided by the querist.

5. The querist has stated that as per Accounting Standard (AS) 11, ‘The Effects of Changes in Foreign Exchange Rates’, the company is required to report foreign currency monetary items using closing rates. Accordingly, the borrowings in foreign currency are required to be restated at the exchange rate prevailing at the reporting date and the difference is required to be taken to the profit and loss account. However, the company has not restated foreign currency borrowings to the extent hedged using closing rates and instead has restated the foreign currency borrowings at the exchange rate prevailing on the date of inception of hedging contract as on account of fluctuation of exchange rate for period from that date would be borne by respective counterparties and will not impact profitability of the company. The querist has further stated that as per RBI Circular No. MPD.BC.187/07.01.279/1999-2000 dated July 7, 1999, the company has also not provided mark to market losses on contracts in nature of cross currency and interest rate swaps as the underlying liability designated with swap is not carried at lower of cost or market value in the financial statements. (Emphasis supplied by the querist.)
6. The company also makes disclosure of accounting practice followed by it in the audited annual accounts in the above matters. However, auditors have qualified the accounts. Relevant extract of notes to the accounts in annual accounts and auditors’ report thereon are given as follows:

a) Notes to the Accounts in Annual Accounts

A note was given in the notes to the accounts in annual accounts for the year ended 31st March, 2010 as under:

“The company has undertaken composite contracts, i.e., interest rate swap cum forward exchange contracts to hedge risks relating to floating interest rates as well as foreign exchange fluctuations on foreign currency borrowings from Asian Development Bank (ADB) of USD 313,515,000 corresponding Rs. 1,45,416.76 lakh up to 31st March, 2010 (Previous Year USD 160,767,000 corresponding Rs. 72,609.87 lacs). As per the Mark-to-Market (M2M) valuations furnished by the counter party banks, the net M2M loss as on 31st March, 2010 on the above composite contracts amounts to Rs. 2,390.84 lacs (gross loss Rs. 4,313.82 lacs less gross gain Rs. 1,922.98 lacs). On account of RBI Circular No. MPD.BC.187/07.01.279/1999-2000 dated July 7, 1999, the above M2M losses on these Interest Rate Swaps (IRS) have not been accounted for in the books of account, since as per RBI guidelines the underlying liability designated with swap is not carried at lower of cost or market value in the financial statements. Further, the M2M loss relating only to IRS cannot be computed separately and provided for as required by the Announcement of ICAI on ‘Accounting for Derivatives’ as the company had entered into composite contracts for hedging.”

The following note was given in the notes to the accounts in annual accounts for the year ended 31st March, 2011:

The company has undertaken composite contracts, i.e., Interest Rate Swap cum forward exchange contracts to hedge risks relating to floating interest rates as well as foreign exchange fluctuations on foreign currency borrowings from Asian Development Bank (ADB) of USD
620,522,000 corresponding Rs. 283,213.83 lacs up to 31st March, 2011 (Previous Year USD 313,515,000 corresponding Rs. 145,416.76 lacs), from Kreditanstalt für Wiederaufbau (KFW) Euro 25,473,600 corresponding Rs. 15,562.94 lacs (previous year Nil) and from World Bank (IBRD) USD 6,487,500 corresponding Rs. 2,887.96 lacs (previous year Nil) up to 31st March, 2011. As per the Mark-to-Market (M2M) valuations furnished by the counter party banks and other valuer, the net M2M gain as on 31st March, 2011 on the above composite contracts amounts to Rs. 398.26 lacs (gross gain Rs. 6,286.60 lacs less gross loss Rs. 5,888.34 lacs). On account of RBI Circular No. MPD.BC.187/07.01.279/1999-2000 dated July 7, 1999, the M2M losses on Interest Rate Swaps (IRS) are not being accounted for in the books of account, since as per RBI guidelines, the underlying liability designated with swap is not carried at lower of cost or market value in the financial statements. Further, the M2M loss, if any, relating only to IRS cannot be computed separately and provided for as required by the Announcement of ICAI on ‘Accounting for Derivatives’ as the company had entered into composite contracts for hedging.”

b) Auditors’ qualification

The statutory auditors of the company have been giving qualification in the auditors report regarding treatment of foreign currency loans raised by the company and their observation in the auditors report on annual accounts for the year ended 31st March, 2010 in this regard was as under:

“As per Announcement issued by the Institute of Chartered Accountants of India (ICAI) regarding ‘Accounting for Derivatives’, the company is required to provide losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market except in respect of forward contracts which are to be accounted for in accordance with the provisions of AS 11, ‘The Effects of Changes in Foreign Exchange Rates’.
In our opinion, the company has not provided for such mark to market losses, amount not ascertained on certain outstanding derivative contracts i.e. interest rate swaps, referred to in note 17(b) of Schedule XX.”

This observation was not repeated in the auditors report on annual accounts for the year ended 31st March, 2011 as the company was not required to provide any mark to market losses as on that date since there was net gain of Rs. 398.26 lakh in composite contracts, i.e., interest rate swap cum forward exchange contracts to hedge risks relating to floating interest rates as well as foreign exchange fluctuations on foreign currency borrowings taken by the company. Further, their observation in the auditors report on annual accounts for the year ended 31st March, 2011 is as under:

“As per Accounting Standard (AS) 11, ‘The Effects of Changes in Foreign Exchange Rates’, foreign currency loans taken (to the extent hedged) and outstanding forward exchange contracts should be restated at the exchange rates prevailing at the reporting date and difference should be taken to profit & loss account whereas the company has restated the above loans at the date of inception of the forward contract and difference taken to Profit & loss account as stated in note B(19) of schedule XX. Had the company complied with AS 11, loan liability and foreign currency receivable account as on 31st March, 2011 would have been lower by Rs. 5595.49 lacs each. However, there would be no impact on the profit for the year as the gain on the principal amount of hedged loans totally offsets the loss on forward exchange contracts.”

7. Accordingly, the querist has approached the Expert Advisory Committee (EAC) of the Institute of the Chartered Accountants of India (ICAI) for seeking opinion regarding appropriate accounting treatment in respect of foreign currency loans to the extent hedged as per accounting standards and other applicable regulations. In this regard, the querist has sought clarification (i) on exchange rate at which foreign currency borrowings to the extent hedged, being covered by hedge contracts in nature of composite contracts, i.e., cross currency and interest rate swap contracts, (ii) on accounting treatment and disclosure requirements of mark to market losses, and (iii) on the basis for segregating the amount of gain/loss on translation of foreign currency
borrowings using closing rate on the date of balance sheet on account of
changes in foreign exchange rate and gain/loss due to movement in floating
rate of interest.

Views of the company

8. The company has not restated the amount of foreign currency
borrowings to the extent hedged using closing rate on the date of balance
sheet. In view of RBI's circular dated July 7, 1999, the company has also
not provided mark to market losses (MTM) on foreign currency loans to the
extent hedged as the underlying liability designated with swap is not carried
at lower of cost or market value in the financial statements.

B. Query

9. In view of the above, the querist has sought the opinion of the Expert
Advisory Committee on the following issues:

(a) Whether it is necessary to restate the amount of foreign currency
borrowings to the extent hedged as well as hedging contract of
principal amount of loan in foreign currency using closing rate on
the date of balance sheet as per AS 11, as gain/loss on account
of fluctuation of exchange rate for the period from date of inception
of hedging contract would be borne by the respective counter
parties. In case this practice is considered necessary by the
EAC of the ICAI, what will be the accounting treatment and
disclosure requirement for amount of gain/loss on account of
fluctuation of exchange rate on principal amount of loan as well
as hedging contract for period from the date of hedging contract
to the reporting date?

(b) Whether it is necessary to account for the mark to market loss
on hedging contracts in nature of interest rate swaps in view of
RBI Circular No. MPD.BC.187/07.01.279/1999-2000 dated July
7, 1999 as the underlying liability designated with swap is not
carried at lower of cost or market value in the financial statements.
In case the practice to account for mark to market gain/loss on
interest rate swaps is considered necessary, how mark to market
gain/loss on interest rate swaps can be ascertained/segregated
from mark to market gain/loss of composite contract?
C. Points considered by the Committee

10. The Committee notes that the basic issues raised by the querist relate to accounting treatment of foreign currency borrowings/loans and MTM gains/losses on swap contract undertaken to hedge the losses on such borrowings/loans. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case. The Committee notes that in the extant case, the company has referred to the RBI Circular No. MPD.BC.187/07.01.279/1999-2000 dated July 7, 1999. Accordingly, the Committee has examined the issues in the context of this circular only. Further, as the company is registered under the Companies Act, 1956, the Committee has examined the issue in the context of Accounting Standards Framework as applicable in case of companies.

11. The Committee notes from the Facts of the Case that the swap in the extant case is a composite contract for principal repayments as well as coupon (interest) payments in line with the underlying loans (refer paragraph 4 above) and that mark-to-market loss relating only to interest rate swap cannot be computed separately as the company had entered into a contract for hedging both the risks of interest rate and exchange fluctuations (refer paragraph 6 above). Thus, the Committee is of the view that the swap in the extant case is a composite cross currency interest rate swap, which hedges both foreign currency risk and interest rate risk.

12. The Committee notes that the foreign currency loan is denominated in USD/Euro and is also repayable in the same currency. The fact that the company has swapped the USD/Euro currency exposure of the foreign currency loan into INR exposure using a swap does not alter this position. The swap does not mean that the company has incurred INR liability to the lender as the swap and the loans are separate contracts. Under the swap agreement, the company gives INR to the counterparty of the swap and that party actually remits USD/Euro to the company as per the agreed rate under the swap contract. Further, the company uses USD/Euro, so received, to settle its liability against foreign currency loans. Thus, the company has the obligation to repay the loan in USD/Euro currency to the lender. The Committee further notes that AS 11 requires separate accounting for forward exchange transactions considering it as a transaction separate from the underlying transaction. Accordingly, the Committee is of the view that the foreign currency loan, which is an underlying transaction, and the swap contract to hedge against any loss arising on the aforesaid loans should be treated as two separate transactions.
13. Accordingly, the Committee is of the view that the foreign currency loan should be accounted for in accordance with AS 11. In this regard, the Committee notes paragraph 13 of AS 11, notified under the Companies (Accounting Standard) Rules, 2006 (hereinafter referred to as the ‘Rules’), which provides as follows:

“13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise’s monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15.”

From the above, the Committee is of the view that at each reporting date, foreign currency loans should be restated at the exchange rate prevailing on that date and exchange differences should be charged to the profit and loss account. In this regard, the Committee notes that the company in the extant case has not restated the foreign currency loans as per the above-mentioned requirements of AS 11 and therefore, is an accounting error, that should be rectified in the current reporting period treating it as a ‘prior period item’ as per the requirements of Accounting Standard (AS) 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’, notified under the Rules.

14. As regards accounting treatment of swap contract, the Committee notes that paragraph 36 of AS 11 deals with accounting for a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. Thus, AS 11 covers forward exchange contracts and other financial instruments of similar nature. However, as discussed in paragraph 11 above, the swap, in the extant case, is a composite cross currency interest rate swap which hedges not only exchange rate risk but also interest rate risk. Accordingly, the Committee is of the view that such swap is not within the scope of AS 11.

15. The Committee further notes that recently, in May 2015, the ICAI has issued a Guidance Note on Accounting for Derivative Contracts, which becomes applicable for accounting periods beginning on or after 1st April, 2016; however, its early application from the date of issuance of this
Guidance Note is encouraged. The Committee further notes that on the Guidance Note becoming effective, in respect of the accounting periods, for which accounts are not yet closed, the company should recognize and measure the outstanding swap contracts in the extant case at their fair value with the corresponding impact recognised in the reserves as a transition adjustment and disclosed separately as per the requirements of the Guidance Note. However, the company is not permitted to follow the hedge accounting as recommended in the Guidance Note retrospectively. Further, in the future, the company should account for the swaps at fair value with changes in the fair value being recognised in accordance with the requirements of the Guidance Note. In this regard, the Committee notes the following paragraphs of the Guidance Note:

“14. The accounting for derivatives covered by this Guidance Note is based on the following key principles:

(i) All derivative contracts should be recognised on the balance sheet and measured at fair value.

(ii) If any entity decides not to use hedge accounting as described in this Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognised in the statement of profit and loss.

(iii) If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify its risk management objective, the risk that it is hedging, how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an ongoing basis.

(iv) An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.

(v) Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements.”

“Transitional provisions

70. This Guidance Note applies to all derivative contracts covered by it
and are outstanding on the date this Guidance Note becomes effective. Any cumulative impact (net of taxes) should be recognised in reserves as a transition adjustment and disclosed separately. An entity is not permitted to follow hedge accounting as recommended in this Guidance Note retrospectively.”

“Effective Date

71. This Guidance Note becomes applicable for accounting periods beginning on or after 1st April, 2016; its earlier application, is encouraged. From the date this Guidance Note comes into effect the following Announcements issued by the Council of the ICAI stand withdrawn:

(i) Applicability of Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction issued on the basis of the decision of the Council at its meeting held on June 24-26, 2004.


With regard to the disclosure requirements, the company should follow the disclosure requirements as prescribed in AS 11 and the Guidance Note.

16. The Committee notes that before the issuance of the Guidance Note, the company had the option either to follow the Announcement on Application of AS 30, Financial Instruments: Recognition and Measurement, issued by the ICAI, as per which, AS 30 can be adopted by an entity to the extent that it does not contradict the requirements of existing notified accounting standards or it could follow the Announcement on Accounting for Derivatives,
as per which, in case the company does not wish to follow the requirements of AS 30, it should have provided for mark-to-market losses in respect of all the outstanding derivative contracts at each reporting date. However, considering the principle of prudence, mark-to-market profits could have been recognised only when realized. Further, the company should also have disclosed the accounting policy for derivative contracts as adopted by it along with a separate disclosure in respect of losses incurred on such contracts in its financial statements. The Committee notes that in the extant case, the company has neither followed the requirements of the Announcement on Accounting for Derivatives nor the requirements of AS 30. Therefore, it is an accounting error and the same should be rectified by adopting one of the afore-mentioned options for prior periods in the current reporting period treating it as a ‘prior period item’ as per the requirements of AS 5, notified under the ‘Rules’.

17. With regard to application of RBI Circular, the Committee notes that the said Circular is applicable in respect of interest rate swap (IRS). The Circular defines interest rate swap and prescribes accounting in respect thereof as follows:

“An Interest Rate Swap (IRS) is a financial contract between two parties exchanging or swapping a stream of interest payments for a ‘notional principal’ amount on multiple occasions during a specified period. Such contracts generally involve exchange of a ‘fixed to floating’ or ‘floating to floating’ rates of interest. Accordingly, on each payment date - that occurs during the swap period - cash payments based on fixed/floating and floating rates, are made by the parties to one another.”

“Interest Rate Swap which hedges interest bearing asset or liability should generally be accounted for like the hedge of the asset or liability.

The Swap that is accounted for like a hedge should be accounted for on accrual basis except the swap designated with an asset or liability that is carried at market value or lower of cost or market value in the financial statements. In that case the swap should be marked to market with the resulting gain or loss recorded as an adjustment to the market value of designated asset or liability.”

Since, in the extant case, the swap is a composite cross currency interest rate swap, which is to hedge both foreign currency risk and interest rate risk, as discussed above, the Committee is of the view that the accounting
prescribed by the Circular in respect of only interest rate swap is not applicable on such composite contracts. Accordingly, the question of ascertainment/segregation of mark to market gains or losses on interest rate swap (IRS) in composite contracts (in view of RBI Circular) does not arise.

D. Opinion

18. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 9 above:

(a) The company should treat the foreign currency loan and the swap contract as two separate transactions. The foreign currency borrowings (whether hedged or unhedged), at each reporting date, should be restated at the exchange rate prevailing on that date and exchange differences should be charged to the statement of profit and loss as per the requirements of AS 11, as discussed in paragraph 13 above. As regards swap, the company should follow the requirements of the Guidance Note on Accounting for Derivative Contracts from the date this Guidance Note comes into effect as discussed in paragraph 15 above. However, before the applicability of the Guidance Note, the company had the option either to follow the Announcement on Application of AS 30, Financial Instruments: Recognition and Measurement, issued by the ICAI, as per which, AS 30 can be adopted by an entity to the extent that it does not contradict the requirements of existing notified accounting standards or it could follow the Announcement on Accounting for Derivatives, as per which, in case the company does not wish to follow the requirements of AS 30, it should have provided for mark-to-market losses in respect of all the outstanding derivative contracts at each reporting date. Since the company has neither followed the requirements of the Announcement on Accounting for Derivatives nor the requirements of AS 30, it is an accounting error and the same should be rectified by adopting one of the afore-mentioned options for prior periods in the current reporting period treating it as a 'prior period item' as per the requirements of AS 5, notified under the 'Rules', as discussed in paragraph 16 above. Further, it should follow the disclosure requirements of the respective Standards, Guidance Note and the Announcement of the ICAI.
(b) As regards, ascertainment/segregation of mark to market gains or losses on Interest Rate Swap (IRS) in composite contracts, the Committee is of the view that since RBI Circular is not applicable in the extant case, the question does not arise, as discussed in paragraph 17 above.

Query No. 10

Subject: Netting off interest income against interest cost in standalone books of parent company.¹

A. Facts of the Case

1. XYZ is one of India’s leading diversified financial services groups. XYZ group offers a broad range of products and services spanning across asset classes and consumer segments. Its businesses are broadly divided into credit including retail finance and debt capital markets, commodities, financial markets, asset management and life insurance. XYZ Ltd. (also referred to hereinafter as the ‘company’) is the ultimate parent of XYZ group and has many subsidiary and associate companies. The company is a category 1 merchant banker registered with the Securities and Exchange Board of India (SEBI). The company’s operations revolve around providing advisory services and merchant banking services (i.e., fee based services) and providing parental support to its group entities in carrying out their respective business activities by way of making investments in subsidiaries or arranging for funding for them.

2. The querist has stated that the company’s principal business activity comprises of advisory and merchant banking activities that require minimal working capital. Further, investments in subsidiaries are made out of the capital funds of the company.

3. Subsidiaries of XYZ Ltd. need to borrow funds for their working capital

¹ Opinion finalised by the Committee on 11.8.2015.
Since XYZ Ltd. enjoys better credit rating, it is able to raise funds at an optimal rate as compared to the rate at which its subsidiaries are able to raise funds. Although XYZ Ltd.'s need for borrowed funds is quite low, it borrows from banks and other lending institutions for lending to its subsidiaries for meeting the subsidiaries' working capital requirements. Such lending to subsidiaries is done at XYZ Ltd.'s average borrowing cost with no markup and consequently, there is no residual cost or gain to XYZ Ltd. XYZ Ltd.'s lending to its subsidiaries and associates at any point of time, is almost equal to the amount of its outstanding borrowings at that time. Thus, in substance, it acts as a ‘pass through’ with respect to loans that it borrows for the exclusive use of its subsidiaries. (Emphasis supplied by the querist.)

4. The querist has also stated that given the above stated economic rationale behind such fund raising and disbursal transactions, XYZ Ltd.'s borrowings and related costs have direct correlation with the funding requirement of the group companies. If funding requirements of the group companies increase, the company will borrow more from lender/institutions and vice versa. So, both these transactions are required to be viewed as linked and correlated. Since, the interest received by the company is equal to its cost of borrowing, the company believes it would be appropriate to offset interest income against interest cost in the presentation of income and expenses in the statement of profit and loss, as this reflects the actual substance of the transaction. Also, the actual net finance costs that would be reflected would be appropriate and attributable to the company’s operations.

5. The key question is whether the presentation of the interest costs incurred on funds borrowed for onward lending to group companies net of the interest income earned from lending these funds to group companies is an appropriate presentation practice in light of existing accounting framework in India, in so far as it relates to the standalone financial statements/financial results of XYZ Ltd.

6. **Company’s analysis:**

Extracts from Accounting Standard (AS) 1, ‘Disclosure of Accounting Policies’:

"Considerations in the Selection of Accounting Policies"

...
17. ...

b. Substance over Form

The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.”

Extracts from the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India:

“25. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.”

“Relevance

27. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.”

(Emphasis supplied by the querist.)

The company’s primary business activity is not lending and consequently, interest income is not its primary source of revenue as it does not enjoy any spread on the monies lent to group companies. As mentioned above, it is a category 1 merchant banker and consequently, fee income is its primary income and is a substantially large contributor to its revenue mix. In a likely situation of its group companies being in a position to self-fund their capital needs, XYZ Ltd. would not have to raise funds and correspondingly not incur borrowing cost, except for a nominal amount for its own funding requirement. By virtue of clear linkage of the borrowings and subsequent disbursal, the company is of the view that both the legs of the transaction are linked, simultaneous and correlated and collectively reflect the substance of the transactions.

7. As per paragraph 4.1 of Accounting Standard (AS) 9, ‘Revenue Recognition’, “In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other
consideration.” The arrangement that the company has with its group companies is akin to an agency relationship where it borrows primarily to lend to its group companies at the same rate of interest as the borrowing. Since the borrowing and lending is akin to agency relationship and does not contribute to the profits/losses of the company as the lending is done at a rate of interest which is the same as the cost of borrowing, it may not be appropriate to present the interest received on lending as revenue but would be more appropriate to net off the same against interest cost.

8. The querist believes that the following further guidance under International Accounting Standards is relevant in this context:

Paragraph 34 of IAS 1, ‘Presentation of Financial Statements’, issued by the International Accounting Standards Board (IASB) reads as follows:

“34. IAS 18 Revenue defines revenue and requires an entity to measure it at the fair value of the consideration received or receivable, taking into account the amount of any trade discounts and volume rebates the entity allows. An entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. An entity presents the results of such transactions, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction. ...”

In the instant case, the company’s business is that of merchant banking and not of lending. Thus, it may not be appropriate to present interest received on loans to subsidiaries as revenue and instead it would be more appropriate to present the same as a ‘net off from interest expenses’. Further, paragraph 13 of IAS 18, interalia, recognises that the revenue recognition criteria “are usually applied separately to each transaction”. However, it goes on to say that “the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole”. As stated earlier, the borrowing is done purely for lending to subsidiaries with interest cost passed on without any margin. Thus, it may be appropriate to consider interest received from subsidiaries, net of the interest paid on the borrowing.

(Emphasis supplied by the querist.)
9. From the above literature, it appears that if interest income and interest expenses are disclosed gross in the financial statements, it may neither be a correct nor an appropriate reflection of the key business activity of the company. It would rather lead to an interpretation that the company is into borrowing and lending activity, which will be an incorrect representation of its operations and business, particularly, when there is simply no loss or gain arising from this activity.

10. Based on the above facts and analysis, the company believes that presentation of net interest cost is appropriate. Further, the company provides a suitable note in its financial statements explaining the rationale for such netting off.

B. Query

11. Based on the facts and the analysis as above, the querist has sought the opinion of the Expert Advisory Committee as to whether the presentation of net interest cost by the company is appropriate under the accounting framework in India.

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to appropriateness of the presentation of net interest cost in the financial statements. 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, accounting treatment and presentation of funds borrowed by the company for its own utilisation, presentation of borrowings from the financial institutions and lending to subsidiaries in the financial statements, presentation of interest cost and interest income in the consolidated financial statements of the company, disclosure requirements as per Accounting Standard (AS) 18, ‘Related Party Disclosures’ and Schedule III to the Companies Act, 2013, accounting treatment of interest in the books of subsidiaries, etc. The Committee wishes to point out that although International Accounting Standards (IASs) have been referred to by the querist, since the query is raised from the perspective of accounting framework in India, the opinion expressed hereinafter, is purely from the existing accounting framework applicable in India.

13. The Committee notes that the existing Indian accounting framework does not contain specific accounting principles for setting off of items of
income and expenses. Accordingly, the Committee notes the general principles of presentation of items of income and expenses. In this context, the Committee notes that one of the major considerations governing the selection and application of accounting policies is ‘Substance over Form’ which is explained in paragraph 17 (b) of Accounting Standard (AS) 1, ‘Disclosure of Accounting Policies’, notified under the Companies (Accounting Standards) Rules, 2006, as follows:

“b. Substance over Form

The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.”

From the above, the Committee notes that the accounting treatment should be governed by the substance of the transactions and events and not by their legal form. The Committee also notes that the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, inter alia, states as follows:

“46. Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.”

“71. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. ...”

From the above, the Committee notes that income and expenses should be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. Further, such presentation should reflect the substance of the transactions and events and should also portray true and fair view of the state of affairs.

14. In this context, the Committee notes from the Facts of the Case that the company’s operations revolve around providing advisory services and merchant banking services (i.e., fee based services) and providing parental
support to its group entities in carrying out their respective business activities by way of making investments in subsidiaries or arranging for funding for them. Further, since XYZ Ltd. enjoys better credit rating, it is able to raise funds at an optimal rate as compared to the rate at which its subsidiaries are able to raise funds and although XYZ Ltd.’s need for borrowed funds is quite low, it borrows from banks and other lending institutions for lending to its subsidiaries for meeting the subsidiaries’ working capital requirements at XYZ Ltd.’s average borrowing cost with no markup and consequently, there is no residual cost or gain to XYZ Ltd. From this, the Committee notes that in order to provide parental support to its subsidiaries, XYZ Ltd. borrows funds generally for meeting the working capital needs of all of its subsidiaries and not on behalf of the subsidiaries (as in the case of agency relationship), for which it charges average borrowing cost of such borrowed funds from its subsidiaries. The Committee is of the view that in the extant case, there are two separate transactions, viz., borrowings from banks and other lending institutions and another, lending to its subsidiaries. Further, the Committee is of the view that since the company is borrowing funds from banks and other lending institutions in its own name, the company is solely responsible for the payment of interest as well as the principal amount. However, collection/recovery of the amount lent to the subsidiaries is a separate transaction different from the borrowing of funds. Accordingly, considering the above substance of the transactions and events in the extant case, the Committee is of the view that the interest/borrowing cost incurred by the company and the interest recovered from its subsidiaries should be presented separately in the statement of profit and loss and not as a set-off against each other.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that the presentation of net interest cost by the company is not appropriate under the accounting framework in India, as discussed in paragraph 14 above.
Query No. 11

Subject: Accounting treatment of deposit of non-refundable upfront premium including processing fee.

A. Facts of the Case

1. A company (hereinafter referred to as ‘the company’ or ‘the corporation’) was incorporated in the year 1976 as a wholly owned Government of India enterprise under the administrative control of the Ministry of Power (MoP) to plan, promote, investigate, survey, design, construct, generate, operate and maintain hydro and thermal power stations and to explore and utilise the power potential of North East in particular. The company is presently running three hydro projects and two thermal projects in North Eastern States and catering to the demand of North Eastern States. The company’s shares are not listed with any stock exchange but bonds are listed in the BSE. The authorised and paid up share capital of the company as on 31.03.2014 are Rs. 5000 crore and Rs. 3385.09 crore, respectively. The turnover of the company for the year ending 31/03/2014 is Rs. 1279.75 crore.

2. The Government of Arunachal Pradesh (GoAP) (hereinafter also referred to as the ‘State Government’) has earmarked certain projects for allocation to private developers, central sector developers, state sector developers for the development of hydro power projects in the State, which will generate economic activity in the State leading to its growth and will also serve as engine to achieve the objective of promoting all round development in the State and the country. The Government of Arunachal Pradesh had permitted the company for carrying out survey and investigations for preparation of the project feasibility report (PFR) of Siang Upper Hydro Electric Project (HEP) in February 2009.

3. The Hon’ble Cabinet, at its meetings on 3rd February, 2013 and 4th April, 2013 has approved the allotment of power project ‘Siang Upper Stage II (3750 MW)’ (hereinafter referred to as the ‘project’) to the company on joint venture (JV) with the Government of Arunachal Pradesh. The project (3750 MW) being established on Siang river in the Upper Siang District of Arunachal Pradesh with FRL at EL 340 M & TWL at EL 235 M including complete hydroelectric power generating facility covers all components such as, dam, intake works, water conductor system, power station generating

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1 Opinion finalised by the Committee on 11.8.2015.
units, project roads, bridges, offices, residential facilities, store, guest houses, security office and other connected facilities including the interconnection facilities.

4. As per clause 2.1 of the Memorandum of Agreement (MoA) between the Government of Arunachal Pradesh and the company, the Government of Arunachal Pradesh granted permission to the company to undertake preliminary investigation for preparation of the pre-feasibility report, detailed investigation for the preparation of the pre-feasibility report, detailed investigation for DPR preparation, financing and subsequent development, commissioning, implementation, operation and maintenance of the project. The project shall be implemented by the company on BOOT (Build, Own, Operate & Transfer) basis for a lease period of 40 years from the commercial operation date (COD). It will be reverted back to the State Govt. on expiry of above lease period, free of cost, in good working condition. However, the company being central public sector undertaking (CPSU), the lease period can be extended beyond 40 years period by the State Govt. on mutual agreement. The entire cost of investigation, DPR preparation, project implementation and subsequent operation and maintenance of the project will be borne by the company.

5. For the aforesaid project, the company was to deposit non-refundable upfront premium including processing fee of Rs. 225.00 crore (Rupees two hundred twenty five crore) only @ 6.00 lakh (Rupees six lakh) per MW of the proposed installed capacity with the State Government. The company has now deposited a sum of Rs. 50.00 crore (Rupees fifty crore) towards non-refundable upfront premium. The company has booked the said expenditure as survey and investigation expenses in capital work in progress (CWIP).

6. The querist has separately clarified that as per clause 2.22 of MoA, the corporation shall be permitted to create a Special Purpose Vehicle (SPV), as defined under the MoA, for implementation of this project as joint venture between the GoAP or any of its entity/agency (fully owned by GoAP) with 26% equity share (to be allocated to the State Government by the joint venture company) and balance by the corporation and another entity, N Ltd., holding equity shares by them. As such, the corporation or the SPV as per clause 2.22 will be responsible for survey & investigation, implementation and subsequent operation & maintenance of the project. Further, as per clause 14.1 of the MoA, the corporation is responsible for payment of non-
refundable upfront premium and processing fees. However, the Ministry of Power, Government of India at its meeting dated 06.06.2014 decided that a JV company shall be formed between N Ltd. and the corporation for the project (3750MW). Accordingly, a Tripartite Agreement between the JV partners and Govt. of Arunachal Pradesh shall be signed for the project in supersession of the MoA already signed between GoAP and the company in respect of Siang Upper Stage-II HEP (3750MW). Therefore, formation of JV between the company and N Ltd. and finalization of tripartite MoA between the company, N Ltd. and the GoAP are in process. The tripartite agreement is yet to be executed between the partners, wherein the above aspects of sharing the upfront non-refundable premium in the proportionate equity ratio shall be taken care of. Further, the querist has stated that the company is the parent corporation for performing the obligations and duties under the MoA till the formation of JV/SPV and accordingly, after the formation of JV/SPV, all the activities of the project under the MoA including construction/development, commissioning, implementation, operation and maintenance shall be undertaken by the JV/SPV.

Audit queries

7. An amount of Rs. 50 crore had been paid as upfront fee (non-refundable) to the Govt. of Arunachal Pradesh in May 2013 for securing the right for construction and operation of Siang Upper Stage-II Hydro Electric Project (3750 MW) in Arunachal Pradesh. However, the project is yet to be approved by the Govt. of India. The company has booked the expenditure as survey and investigation (S&I) expenses in capital work in progress (CWIP). Such expenditure does not relate to acquisition/construction of an asset and is in the nature of cost of prospecting activities. Accordingly, this should be charged off as revenue expenditure as and when incurred. Non-compliance of this has resulted in overstatement of CWIP by Rs. 50 crore with corresponding overstatement of profit.

Reply of the management

8. The company has paid Rs. 50.00 (fifty) crore being part of the non-refundable upfront fees to the Govt. of Arunachal Pradesh (GoAP) in May 2013 for securing the right for construction and operation of Siang Upper Stage – II Hydro Electric Project (3750 MW) in Arunachal Pradesh. The upfront fees was paid by the company as per the Memorandum of Agreement (MoA) signed. The MoA was prepared in line with the conditions mentioned in clause 9.13 of the Hydro Policy 2008; Arunachal Pradesh. As per the said
Hydro Policy, the interested power producers have to pay non-refundable upfront fees to the GoAP before taking up the construction activity.

9. The management of the company is of the view that this expenditure can be capitalised in view of paragraph 9.2 of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, notified under the Companies (Accounting Standards) Rules, 2006, which inter alia, states that such expenses, which are specifically attributable to construction of a project or to the acquisition of fixed asset or bringing it to its working condition, may be included as part of the cost of the project. This is also in accordance with the approved accounting policy No. 2(b1) of the company. The company is of the view that the basic principle to be applied while capitalising an item of cost to the cost of fixed asset(s)/project under construction/expansion is that it should be directly attributable to the construction of the project/fixed asset(s) for bringing it to its working condition for its intended use. The costs that are directly attributable to the construction/acquisition of fixed asset(s)/project for bringing it to its working condition are those costs that would have been avoided if the construction/acquisition had not been made. These are the expenditures without the incurrence of which, the construction of project / asset(s) could not have taken place and the project/asset(s) could not be brought to its working condition.

10. The company notes that the accounting principles for determination of the cost of a self-constructed fixed assets have been laid down in paragraph 10.1 of AS 10, which provides as follows:

“10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.”

The company further notes paragraphs 9.1 and 9.2 of the notified AS 10 as reproduced below:

“9.1 The cost of an item of fixed asset comprises its purchase price,
including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. …

9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.”

From a combined reading of the above paragraphs of AS 10, the company is of the view that the basic principle to be applied while capitalising an item of cost to fixed asset(s)/project under construction is that it should be directly attributable to the construction of the project/fixed asset(s) for bringing it to its working condition for its intended use. The company further notes the lines mentioned in paragraph 9.1 of AS 10 which states that the cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes and levies. (Emphasis supplied by the querist.)

11. In this connection, the querist has referred to the word ‘levies’ as mentioned in the above paragraph. The connotation of the word levies, as per dictionary, is “impose or collect compulsory/statutory payment etc.”. The right to start the project activity including S & I works will be enjoyed by the power producer in Arunachal Pradesh only when the company makes such non-refundable upfront fees to the GoAP. Such collection of non-refundable fees by the State Government is as per Hydro Policy of Arunachal Pradesh which has been approved by the Legislative Assembly of the State. (Emphasis supplied by the querist.)

12. Further, the management of the company notes that paragraphs 49 and 88 of the ‘Framework for the Preparation and Presentation of Financial Statements’, issued by the Institute of Chartered Accountants of India (ICAI) give the following definition towards recognition criteria for an asset:

“An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.”
“88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.”

On the basis of the above, the management is of the view that the expenditure incurred by the company is to be recognised as an asset since the enterprise enjoys the rights to start the project activity and will have a capacity to control the benefits and the enterprise can also restrict the access of others to the benefits arising from it. The management further opines that the probable future economic benefits will flow to the company from the asset(s) created. Thus, the non-refundable upfront fee paid by the company is to be recognised as asset and cannot be treated as cost of prospecting activity.

13. The querist has further stated that in case the above expenditure is charged off to revenue consequent to the observation given by the Comptroller and Auditor General (C&AG), this expenditure will neither be serviced as part of project cost (fixed charges) nor it will be allowed as a part of operation and maintenance (O&M) charges as provided by the CERC in the tariff regulations. Accordingly, charging off the expenditure will not be in line with the true spirit of the Hydro Policy 2008 of GoAP nor it will satisfy the basic intention of the tariff regulations notified by the CERC, which is based on cost plus return basis. The charging off such expenditure to the profit and loss account shall also not be in accordance with the provisions of AS 10. From the above, the company is of the view that the non-refundable upfront fees paid to GoAP as per MoA as well as Hydro Policy 2008, is to be recognised as an asset.

14. The querist has also separately clarified that in principle, it is agreed by the Govt. of Arunachal Pradesh and MoP, Govt. of India to allot the above projects to JV company as above. Hence, there is no uncertainty involved as far as final allotment of the project is concerned. However, after submission of DPR of the project and till obtaining of all the clearances from the authorities, such as, techno-economic clearance (TEC), environment & forest etc. as required by Central Govt./State Govt., there will be some element of uncertainty involved so far as capacity and implementation of the project is concerned.

B. Query

15. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
(i) Whether the accounting treatment adopted by the company is in compliance with the existing accounting standards and as per the standard accounting principles.

(ii) Whether the expenditure incurred by the company should be treated as asset or cost of prospecting activity.

C. Points considered by the Committee

16. The Committee notes that the basic issues raised in the query pertain to accounting treatment of deposit of non-refundable upfront premium including processing fee (also referred to as 'premium') paid for the project in the financial statements of the company. 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, accounting for lease of land, propriety of using the nomenclature of survey and investigation (S&I) expenses for booking the expenditure on non-refundable upfront premium, accounting treatment of the said premium for the purpose of joint venture accounting, etc. Further, the opinion expressed, hereinafter is purely from accounting perspective and not from the perspective of legal interpretation of MoA or the Hydro Policy, 2008 or the tariff regulation of CERC, etc. At the outset, the Committee presumes from the Facts of the Case that non-refundable upfront premium including processing fee is a composite amount that is payable to the State Government as per the terms of the MoA rather than of the nature of expenses, such as, legal or documentation preparation expenses incurred by the company in the process of obtaining the right to commence the project. Further, the Committee also presumes that the company in the extant case is not acting as an agent on behalf of the J.V or S.P.V. company which is in the process of formation.

17. The Committee notes that the accounting for non-refundable upfront premium including processing fee would depend upon the nature of expenditure. Therefore, for examining the nature of the expenditure, the Committee notes the following paragraphs of Memorandum of Agreement (MoA) between the Government of Arunachal Pradesh (the State Govt.) and the company for execution of Siang Upper Stage-II hydro electric project (HEP) (3750 MW) on Siang River in Arunachal Pradesh and Arunachal Pradesh State Hydro power Policy, 2008:
Memorandum of Agreement (MoA)

“14.1 For Siang Upper Stage-II HEP (3750 MW), the corporation has to deposit non-refundable upfront premium including processing fee of Rs. 225.00 Crores (Rupees Two Hundred Twenty Five Crores) only @ Rs. 6.00 lakhs (Rupees Six Lakhs) per MW of the proposed installed capacity. The corporation has now deposited a sum of Rs. 50.00 Crores (Rupees Fifty Crores) ... Rs. 50.00 (Rupees Fifty Crores) shall be deposited within 4 (four) months time and balance amount of Rs. 125.00 (Rupees One Hundred Twenty Five Crores) shall be deposited to the State Govt. on or before 31st December 2013, failing which the State Govt. reserves the right to terminate the agreement for which the non-refundable upfront premium including processing fees of Rs. 100 Crores (Rupees One Hundred Crores) shall stand forfeited.”

Arunachal Pradesh State Hydro Power Policy, 2008

“9.13 The developer(s) of viable project(s) shall have to deposit non-refundable “Upfront Premium” including Processing Fees as stipulated hereunder:-

<table>
<thead>
<tr>
<th>Project Capacity</th>
<th>Minimum Upfront Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>25MW-100 MW</td>
<td>Rs. 1.00 Lakh per MW</td>
</tr>
<tr>
<td>101 MW-500 MW</td>
<td>Rs. 2.50 Lakhs per MW</td>
</tr>
<tr>
<td>501 MW-1000 MW</td>
<td>Rs. 3.50 Lakhs per MW</td>
</tr>
<tr>
<td>1001 MW-2000 MW</td>
<td>Rs. 5.00 lakhs per MW</td>
</tr>
<tr>
<td>2000 MW and above</td>
<td>Rs. 6.00 Lakhs per MW</td>
</tr>
</tbody>
</table>

(Emphasis supplied by the Committee)

From the above, the Committee notes that the MoA in the extant case provides the permission to the corporation to undertake preliminary investigation for preparation of the pre-feasibility report, detailed investigation for the preparation of the pre-feasibility report, detailed investigation for DPR preparation, financing and subsequent development, commissioning, implementation, operation and maintenance of the project. The Committee further notes that as a part of the MoA, apart from various payments/obligations, such as, lease payments for acquisition of site, afforestation
Charges, rehabilitation and resettlement, etc., the company has to deposit the prescribed non-refundable upfront premium including processing fee for a specified project capacity (MW) and the failure in payment of such a premium would result in the cancellation of the agreement. Accordingly, the Committee is of the view that payment of the premium is a pre-condition to commence the project activity and is also an integral part of the overall arrangement (MoA), as the company will not be allowed to proceed further without such payment and the State Government reserves the right to terminate the agreement.

18. The Committee further notes from the Facts of the Case that the Cabinet has approved the allotment of power project ‘Siang Upper Stage II (3750 MW)’ to the company on joint venture with the Government of Arunachal Pradesh which includes creation of complete hydroelectric power generating facility covering all components such as, dam, intake works, water conductor system, power station generating units, project roads, bridges, etc. The project shall be implemented by the company on BOOT (Build, Own, Operate & Transfer) basis for a lease period of 40 years from the commercial operation date (COD) and it will be reverted back to the State Govt. on expiry of the above lease period, free of cost, in good working condition. The Committee further notes that as a part of allotment of this project, the company has to deposit a non-refundable upfront premium including processing fee, which as per the querist, shall provide to the company, the right for construction and operation of the Project. In this context, the Committee is of the view that to determine the accounting for non-refundable upfront premium including processing fee, it is important to understand the nature of the arrangement under which such deposit is being made and the asset, if any, that the company is acquiring out of such arrangement. In this context, on a perusal of the terms of the MoA between the Government of Arunachal Pradesh and the company for execution of the Project, the Committee is of the view that the company in the extant case has obtained from the Government, only a right to construct, implement and operate the project that will be transferred back to the Government and therefore, the company can recognise only an intangible asset for such a right following the provisions of Accounting Standard (AS) 26, ‘Intangible Assets’. In this regard, the Committee notes the definitions of the terms ‘intangible asset’ and ‘asset’ given in paragraph 6 of Accounting Standard (AS) 26, ‘Intangible Assets’, and meaning of ‘control’ dealt with in paragraph 14 thereof as reproduced below:
“6.1 An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

6.2 An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.”

“14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.”

The Committee notes from the above that an item can be classified as an intangible asset only if it fulfils all the three conditions: (a) it is identifiable, (b) the enterprise has control over the resource, and (c) it is expected that future economic benefits will flow to the enterprise. The Committee notes that in the extant case, in lieu of the construction and development services related to the power project, the company has been granted an exclusive right to construct, implement and operate the project that shall provide economic benefits to the company from the sale of power generated out of such project on its commissioning. Thus, such an arrangement (MoA) gives rise to an intangible asset that should be recognised in the books of account of the company. The Committee is further of the view that out of the various conditions, activities and obligations to be complied with/undertaken under such an arrangement, one of the condition is to deposit the non-refundable upfront premium including processing fee depending upon the power capacity (MW) of the project. Accordingly, the Committee is of the view that such a deposit is a part of the intangible asset being recognised under the
arrangement as afore-mentioned and, therefore, the deposit of premium should be recognised as ‘intangible asset under development’ under the head ‘intangible assets’ in the books of account of the company.

19. With regard to the auditor’s argument that such expenditure does not relate to acquisition/construction of an asset and is in the nature of cost of prospecting activities as the project is yet to be approved by the Government of India, the Committee notes from the Facts of the Case that the querist has stated that there is no uncertainty involved as far as final allotment of the project is concerned. However, after submission of DPR of the project and till obtaining of all the clearances from the authorities, there will be some element of uncertainty involved so far as capacity and implementation of the project is concerned. Considering this being the true position, the Committee is of the view that if there is no uncertainty regarding final allotment of the project and future economic benefits are expected to flow to the company, non-refundable upfront premium including processing fee should not be considered as the cost of prospecting activities; rather it should be treated as a part of an intangible asset, as discussed above.

D. Opinion

20. (i) and (ii) On the basis of the above, the Committee is of the opinion that the deposit of non-refundable upfront premium including processing fee should be recognised as an ‘intangible asset under development’ under the head ‘intangible assets’ in the books of account of the company, rather than as survey and investigation expenses under ‘capital work in progress’ and, therefore, the accounting treatment adopted by the company is not in compliance with the existing accounting standards and as per standard accounting principles, as discussed in paragraph 18 above.
Query No. 12

Subject: Accounting treatment of various kind of budgetary support received from the Government and various types of expenditure incurred by the company.¹

A. Facts of the Case

1. A company is incorporated under the provisions of the Companies Act, 1956. The authorised share capital of the company is Rs. 12,000.00 crores. The subscribed and paid up capital is Rs. 7095.00 crores as at 31-03-2014. The entire share capital is presently held by the Government of Karnataka (96.94%) and Karnataka State Financial Corporation, a Government of Karnataka undertaking (3.06%).

2. The main objectives of the company is executing the Upper Krishna Multipurpose and other irrigation projects as per the directions of the Government of Karnataka (also referred hereinafter as ‘the State Government’) including rehabilitation and resettlement of the project affected people. The company was formed in the year 1994 and commenced its business with effect from 14.11.1995. The assets of the then ongoing Upper Krishna Irrigation Project which was being implemented by the Water Resources Department of the Government of Karnataka along with selected liabilities were transferred to the company on 14.11.1995. Further works are carried out by the company. The company was preparing ‘Expenditure Pending Capitalisation Account’ upto financial year 2006-07. On substantial completion of the project, the company started preparing profit and loss account from the year 2007-08. The expenditure incurred on the completed project components have been capitalised in the books of account of the company.

3. The company does not have sufficient operational income from its core assets to meet the project expenditure. The project cost has therefore been partially funded by budgetary support from the Government of Karnataka and partially by borrowed funds, i.e., funds raised through bonds and term loans from banks and financial institutions. The Government of Karnataka also funds the repayment of principal and payment of interest on the borrowed funds. The querist has separately clarified that the Government of Karnataka was releasing funds required for the purpose of implementation of the

¹ Opinion finalised by the Committee on 11.8.2015.
irrigation projects through the budget allocation to the company as advance against equity till the company was preparing ‘Expenditure during Construction period (pending Capitalisation) Account’ upto the year 2006-07, for which equity shares were allotted to the Government. Further, the Government of Karnataka started releasing budget allocation in the form of grant when the company started preparing profit and loss account from the year 2007-08 after substantial completion of the project. Thus, the Government of Karnataka is the major shareholder of the company. The Government of Karnataka also guarantees the borrowings of the company for project finance and since the company does not have sufficient income streams of its own to service the principal and interest of the borrowings, it provides funds for repayment of the principal and interest on the borrowing. According to the querist, as far as funds released by the Government for the purpose of repayment of borrowings, the Government as the owner of the company replaces the borrowing with the owners’ funds.

4. The company has also created some non-core assets like roads, culverts, bridges and filling of minor irrigation tanks etc., as per directions of the Government. The capital expenditure grants released by the Government are also allocated to these works as per the approved programme of works. Expenditure incurred on such assets are shown in the books as ‘Assets held for transfer to Government’ under ‘Tangible Assets’.

5. The querist has stated that the company prepares tentative project-wise budget requirement and submits the same to the Government for providing budget allocation each year. (One such request for the year 2012-13 has been provided by the querist for the perusal of the Committee.) As per the querist, the project is to be reckoned as an asset. The budget allocation is intimated by the Government to the company. (One such intimation for the year 2012-13 has been provided by the querist for the perusal of the Committee.) The querist has separately clarified that the Government, considering the request for the project-wise requirement of funds of the company, makes budget allocation (lumpsum) and intimates the same to the company. At the time of preparing and approving the annual programme of works, i.e., programme of capital expenditure, the company allots specific funds to each component of a project. The company is of the opinion that the requirement of paragraph 14 of Accounting Standard (AS)12, ‘Accounting for Government Grants’ is fulfilled. The company requests the Government for release of funds based on the budget allocation and the Government releases the same in the form of grant. Even though the term
‘budgetary support’ has been used in this query, the funds received from the Government are in the nature of grants only, except in case of funds released by the Government for repayment of principal of the term loans from banks and funds raised by the company. (Emphasis supplied by the querist.)

6. The querist has further stated that based on the budget communication to the company, the company prepares the programme of works detailing the funds required for each capital works (indirect expenditure on projects), establishment expenditure, Bagalkot Town Development Authority (BTDA) (an autonomous body created by the Government for rehabilitating the people of Bagalkot town which is partially submerged in the backwaters of Almatti Dam constructed by the company), creation of Field Irrigation Canal (FIC), Command Area Development Authority (CADA) (a Government Department created by the Government of Karnataka for carrying out the command area development works, funded by the company), rehabilitation and resettlement (R&R) works of rural population affected by the project and debt servicing, i.e., (i) for payment of interest on borrowings and (ii) payment of principal amount. The annual programme of works based on the budget provision communicated by the Government is approved by the board of the company and the company takes up the works and effects payment for the items in the annual programme of works approved by the board. However, specific grants are allocated by the Government for Special Component Plan (SCP) and Tribal Sub Plan (TSP) works, maintenance expenditure for assets, principal repayment and interest payment.

7. The Government, after considering the funding requirement for the year under various heads, also indicates the extent of funds, the company has to mobilise for the project expenditure from market borrowings. Depending on the market conditions, the company issues bonds in the nature of debentures on private placement basis or through availing term loans from the banks. These borrowings are secured by the assets of the company. These are long term funds repayable in 7 to 10 years and are backed by the Karnataka Government guarantee for payment of interest and principal during the life of these debts. As per the terms of sanction/issue of these loans and bonds, the Government releases specific separate grants for making interest payment and separately for meeting liability for repayment of principal amounts. The querist has also separately clarified that funds are raised through term loans from banks and bonds to augment the grants released by the Government to meet the project expenses. The borrowings are not project specific and are generally to be used for all the
projects being implemented by the company. The term loans are generally
tenure of 7 years with a moratorium of three to four years and are being
repaid in four/three annual installments. The interest on the term loan is
serviced each month. The bonds are for a period of 10 years with an option
to exit at the end of 7 years. The interest on the bonds is serviced on yearly
basis. The utilisation of the funds borrowed cannot be related to a particular
work and the funds are released to project offices for making payments out
of pooled funds, i.e., grants received from the Government, borrowed funds
and internal accruals.

Scheme of budgetary support received from the Government in the nature
of grants

8. The company prepares each year tentative budget requirement and
submits the same to the Government for providing budget allocation. The
budget allocation is intimated by the Government to the company. The
budget heads under which the Government communicates the grant of funds
to the company are as follows:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Budget Head</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Accelerated Irrigation Benefit Programme (AIBP)</td>
<td>Capital expenditure on specific projects. Part of the fund is released by the Government of India and part of the fund is released by the State Government to meet part expenditure on these projects.</td>
</tr>
<tr>
<td>2</td>
<td>AIBP SCP (Special Component plan) AIBP (Tribal Sub Plan)</td>
<td>These are mandatory expenditure to be incurred by the company on specific components and specific grants are released for these expenditure.</td>
</tr>
<tr>
<td>3</td>
<td>Capital expenses</td>
<td>Amount released under this head are further allocated by the company between capital expenditure on the project, rehabilitation and resettlement of project affected families of urban and rural areas (R&amp;R), land acquisition for the project, command area development (CADA), and day to day administrative and running</td>
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<tr>
<td></td>
<td>expenditure of the company and establishment expenditure.</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Capital expenditure On SCP and TSP</td>
<td>Specific grants released by the Government for specific components of the works</td>
</tr>
<tr>
<td>5</td>
<td>Debt servicing a) For repayment of bonds and loans b) For payment of interest on bonds and loans</td>
<td>Specific grants released by the Government under each sub head, separately for payment of interest and principal.</td>
</tr>
<tr>
<td>6</td>
<td>Maintenance and repair</td>
<td>Specific grant released by the Government for meeting expenditure on repairs and maintenance of assets of the company.</td>
</tr>
</tbody>
</table>

9. The querist has separately clarified that the Government releases grants to the company under the following heads:

(i) Specific Grants
   (a) SCP and TSP Grants
   (b) Maintenance Grant
   (c) Principal repayment
   (d) Interest payment
   (e) AIBP

The above are the specific grants released by the Government to the company and are to be used only for meeting expenditure of the specific works/projects.

(ii) Other Grants
   (a) Capital Grant

This is not a specific grant and these grants released by the Government to the company are utilised for capital expenditure on the project and project revenue expenditure. Besides, a part of this grant is also used for revenue
expenditure like salary and employee payment and other administrative expenditure.

**Grant for capital expenses/Capital Grant**

10. This is a grant released by the Government mainly for meeting capital expenditure of ongoing projects and fresh projects proposed to be taken up by the company and to meet incidental expenditure. The extent of grant is determined by the Government keeping in view the projects to be/being executed by the company, and the inter se allocation of the funds to the individual project/work is made by the board of the company. However, the Government does not specify the specific asset/assets/project on which such grants are to be used. The grants received from the Government are utilised for expenditure as per approved programme of work. The capital expenditure on the project is also met from borrowed funds as well as other income like interest on short term investment of temporary surplus funds etc.

11. Grants received from the Government and spent on the capital assets, capital work in progress, assets held for transfer to the Government are allocated for these items of works. The allocated grants are accounted as under:

   a. Government grants apportioned to capital works comprising of dams, canal systems, lift irrigation schemes, etc., are reduced from the value of the assets created and depreciation is provided on the net asset value.

   b. Government grants apportioned to Capital Work in Progress are disclosed as Deferred Government Grants under the head “Other Long Term Liabilities”. When once the asset is capitalised, the item will be taken to the asset head and the grants relating to this asset is treated as stated at item (a) above.

   c. Government grants relating to assets held for transfer to government are reduced from the value of the assets created and held for transfer.

12. The accounting policy adopted by the company with regard to ‘Government Grants’ as related to capital and revenue expenses is reproduced below:
9. Significant Accounting policy - Government Grants:

9.2 The Grants received from the Government are apportioned for Capital works, Assets held for transfer to Government, and revenue expenditure based on expenditure incurred towards approved component of works and other payments.

9.3 Grants apportioned as enumerated at (a) above towards capital expenditure are reduced from the value of fixed assets at the time of capitalization.

9.4 Grants apportioned as stated above, towards Capital work in progress is treated as “Deferred Government Grants” and shown under “Other Long term Liabilities”.

9.5 Grants apportioned towards revenue expenditure are treated as income.

9.7 Grants apportioned towards assets held for transfer are reduced from the value of the Assets held for transfer.

9.8 The funds released to BTDA, R&R and CADA are netted off against the grants allocated for the said purpose.

**AIBP Grants**

13. In order to speedily complete the ongoing irrigation projects approved by the Ministry of Water Resources, Government of India and having investment clearance by the Planning Commission, Government of India, the Government is releasing central assistance in the form of grants being a portion of the capital expenditure on these specified works to the State Government. The State Government in turn releases the same to the company along with the State share as per the terms and conditions of release. A copy of the guidelines of the release by the Central Government has been provided by the querist for the perusal of the Committee. The querist has also stated that since the grants under AIBP are insufficient to complete these works, releases by the State Government under the head capital grant at sl. no. 8(3) as well as borrowed funds will also be utilised for capital expenditure of these works. The extent of release of funds under the head AIBP will be a specific grant for AIBP work. Since the expenditure is met from multiple sources, the releases from the Government under AIBP is also treated as capital grant, and treated accordingly in the books. They are
Compendium of Opinions — Vol. XXXV

treated in the accounts at par with grants for capital expenditure. (Refer to the accounting policy No.9.2 enumerated above.)

Grant for CADA

14. Certain assets like roads, bridges, culverts, tank filling works are created within the overall command area of the irrigation projects. Such assets will be ultimately transferred to Government departments like PWD, RDPR, Minor Irrigation Department etc. Such assets are held temporarily by the company and hence, they are separately disclosed as assets held for transfer to Government. For treatment of grants, refer to Significant Accounting Policy No. 9.7 enumerated above. The querist has separately clarified that command area is the area which can be irrigated from an irrigation project/scheme and is fit for cultivation. The activities involve construction of field canals for carrying water from canal outlet up to the farms and field, intermediate and link drains. These activities are carried out by Command Area Development Authority (CADA), a Government Authority.

15. The querist has stated that the irrigation systems created by the company consist of dams, barrages, lift irrigation schemes, tanks, canal systems etc. The canal system up to the laterals are created on the lands acquired for that purpose and the expenditure incurred for the same is capitalised in the books of the company once the schemes are substantially completed. However, the field irrigation canals created from the company’s funds in the farmers agricultural field do not belong to the company. As such, the company has not capitalised the expenditure incurred for Field Irrigation Canals (FICs). Pending formalisation of a suitable accounting policy, the company has been reflecting the same under advance to Government / Government agencies (Refer to Note no. 2.11 – Long term Loan and Advances). In this regard, the querist has also clarified that the irrigation projects contain several components. The components are - a dam, a canal system including distributary canals, and canal system up to the outlet point (just prior to the farmer draws water in his field irrigation canal). It is the responsibility of Command Area Development Authority (CADA) to create the field canals on the lands of the farmers. The field irrigation canals are created for carrying water from canal outlet up to the farms and field, intermediate and link drains. Ultimately, without the field irrigation canal, water cannot be put to use by the farmer.

16. The objective of creating field irrigation canals is to bridge the gap between the irrigation potential created at the outlet and that utilised through
micro level infrastructure development and efficient farm water management practices for optimising agricultural productivity and production and improving socio-economic condition of farmers. The project is fully complete if water is used by farmers through the irrigation facilities created. Thus, FICs created by CADAs from funds provided by the company is critical to the irrigation project. However, since the underlying land for creating the FICs is not acquired by the company, the amounts spent on the fields of the farmers for creation of FICs are treated as advance to CADA under 'Advance to Government /Government Agencies'. This could be capitalised by allocating the expenditure for FICs to the capitalised cost of the canal systems. In this regard, the querist has also clarified that there is no specific grant received from the Government by the company for CADA, BTDA and R&R works. But grants indicated by the Government under capital head are allocated specifically to CADA, BTDA and R&R works by the company. The general capital grant funds and borrowed funds, if any, are spent on CADA, BTDA and R&R works.

Grants for Interest Payment

17. The querist has stated that the company does not have sufficient operational income to meet the liability of payment of interest on the borrowed funds. As such, such obligations are met out of the government grants specifically released for payment of interest (a copy of the Government order releasing interest has been furnished by the querist for the perusal of the Committee). The same is disclosed in the books as follows:

"Government grants received from Government towards meeting interest liability is treated as income" since it is a specific grant and interest payment is disclosed as expenses under Finance Cost. Since the interest expenditure is met out of specific grant given by Government for this purpose, the interest cost, though, considered under the finance cost, is not allocated as incidental expenditure as the full liability is met out of the Government grant released for this specific purpose under the Govt budget head 2701-80-190-0-01-240.

SCP and TSP grants:

18. Special Component Plan (SCP) and Tribal Sub-Plan (TSP) were initiated by the Government as strategies to cater exclusively to scheduled castes (SC) and scheduled tribes (ST) respectively. Such plans are meant to ensure benefits to these special groups by guaranteeing flow of funds from the
Government. The Government makes/releases specific funds for such expenditure. The details and nature of works taken up under Special Component Plan (SCP) and Tribal Sub Plan (TSP) are given below:

(a) Providing irrigation facilities by providing bore wells with electrification, ponds, check dams, drinking water facility etc.

(b) Construction of SC/ST community centres, SC, ST colony street lights, toilets etc.

(c) Construction of roads and drains in the SC/ST colonies.

Such expenditure is incurred on creation of these facilities for the SC/ST beneficiaries and such facilities are transferred to the beneficiaries once the assets are completed. These expenditure will not create any asset to the company and hence not treated as capital expenditure. The querist has also stated that it is mandatory for the State Government for spending 17.15% of the budget allocation towards Special Component Plan and 6.95% towards Tribal Sub Plan. When budgetary allocation is made to the company, the Government indicates specific amount to be spent by the company to benefit the specific beneficiary groups. Since the company is receiving budget allocation from the Government towards capital expenditure, it is mandatory for the company to also take up the SCP and TSP works, even though such works are not incidental or a part of the capital projects of the company. Since these assets are handed over to the beneficiary groups after the expenditure is incurred these assets cannot be capitalised in the books of the company and hence these expenditure are treated as expenditure in the profit and loss statement under ‘SCP/TSP works’. (Refer Note No. 2.22 - Other Expenses, in 2012-13 Annual Report.) The specific grant received is also taken to the profit and loss statement as income under Government Grants for SCP/TSP works. (Refer item (b) ix in Note No. 2.19.) Any unspent amount of the grant at the end of the financial year is reflected under deferred government grant under ‘Other Current Liabilities’ and utilised during the next financial year.

Rehabilitation and resettlement

19. Rehabilitation and resettlement of the project affected people involves shifting of the affected people and resettling them in rehabilitation centers after providing basic infrastructure facilities in the rehabilitation centers (RCs). Part of a township called Bagalkot Town also got submerged in the back
waters of Almatti Dam constructed by the company. While the rehabilitation of affected rural population is carried out by the Revenue Department of Government of Karnataka headed by the Commissioner, Rehabilitation, the resettlement of the population affected at the Bagalkot Town is carried out by the Bagalkot Town Development Authority (BTDA) created under the provisions of a special Legislation of the Karnataka Government called the ‘Bagalkot Town Development Act, 1993’. The Act provides for establishment of separate authority to plan, develop and manage the resettlement and rehabilitation of the project displaced families of the submerged Bagalkot Town by creating a new township by providing necessary infrastructure like roads, water supply, underground drainage, electrification and public buildings etc. The funding of the entire R&R activity both under the BTDA and the rural R&R is made by the company. As such, the expenditures incurred are part of and incidental to the overall project cost. However, the assets created will not be assets of the company as the infrastructure created will have to be transferred to the Bagalkot Town Development Authority (BTDA) in respect of Bagalkot Town and to the ZillaPanchayats in respect of rural rehabilitation and resettlement, as the case may be.

20. Grants received from the Government, allocated and spent on rehabilitation and resettlement (R & R), Bagalkot Town Development Authority (BTDA) together with funds released from the borrowed funds are accounted as advance to BTDA and advance to Rehabilitation and Resettlement Authority. The apportioned capital grants are reduced from the advance to these entities, and the net amount is shown as advance to BTDA, Advance to R&R etc. These accounts will be squared off when the assets are transferred to the various departments as enumerated above.

*Land Acquisition*

21. The land required for the submergence under the dams, land required for creation of canal systems, lift irrigation schemes, land required for creating township, rehabilitation centers, staff colonies, roads and quarries for exploiting project construction materials is acquired by the Commissioner, Land Acquisition from the funds provided by the company from the capital grants and borrowed funds. The land acquired from the funds provided by the company are treated as assets under ‘Land and submergence’ in the books of the company. Initially, funds are released to the LAQ and RR authority and accounted as advance to the Government/Government Departments pending furnishing of the full details of land acquired,
rehabilitation expenditure incurred by the concerned authority. The Grant apportioned to this account will be reduced from the land value at the time of capitalisation.

The querist has also provided the details of various expenditure incurred as follows:

Expenditure on Roads: The expenditure on roads are incurred from the common capital grants released by the Government. Since some of the roads though, come under the project area they are held as assets held for transfer to the Government.

Quarries: For construction activity, the company’s contractor need to use construction material like sand, soil, metal (stones) etc. The land in which the sand, soil and metal (stone) quarries are situated is acquired by the company for taking out these materials for use in the Project construction work. The land acquired is capitalised in the books of the company as ‘Land’ and reflected in the ‘tangible assets’ Note.

In this regard, the querist has also clarified that the land acquired by the company for project implementation is owned by the company. The company has control over the land being the owner. The ownership of land in favour of the company is established through mutation entries in favour of the company in the revenue records of the Government of Karnataka.

22. The statutory auditors of the company have expressed reservation over the accounting treatment of grant received in their audit report on the financial statements for the year ended 31.3.2013. Refer paragraph 1(c) of Basis for Qualified Opinion annexed as Annexure A to the audit report. The auditors have also qualified the method of accounting expenditure on rehabilitation and resettlement, BTDA and CADA (See paragraph 1(d) of Annexure A in the company’s 19th Annual Report.) The copy of the statutory auditors observation on the accounting of Government Grants has been provided by the querist for the perusal of the Committee.

B. Query

23. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Accounting treatment of budgetary support received from the Government for meeting capital and revenue expenses.
(ii) Accounting treatment of budgetary support received from the Government relating to assets held for transfer to Government/Government agencies.

(iii) Accounting treatment of budgetary support received from the Government for meeting expenses on accelerated irrigation benefit programme.

(iv) Accounting treatment of budgetary support received from the Government for servicing interest on long term loans such as bonds and term loans.

(v) Accounting treatment of budgetary support received from the Government for meeting expenses of Special Component Plan (SCP) and Tribal Sub Plan (TSP).

(vi) Treatment of expenses incurred on rehabilitation and resettlement (R&R) activity due to relocation of Bagalkot Town through Bagalkot Town Development Authority (BTDA), and rural R&R where the assets created will not be the assets of the company.

(vii) Treatment of expenses incurred on land acquisition for submergence under the dams, creation of canal systems, lift irrigation schemes, creating township, rehabilitation centres, staff colonies, roads and quarries for exploiting project construction material etc., out of the funds provided by the company.

(viii) Accounting treatment of creation of field irrigation canals in the farmers’ fields by the Command area Development Authority (CADA) from the funds provided by the company which do not belong to the company.

(ix) Accounting treatment of Government grants received and spent on R&R, BTDA and CADA.

(x) Treatment of interest payment on long term loans/bonds etc., in respect of capital projects/capital expenses incurred.

C. Points considered by the Committee

24. The Committee, while expressing its opinion, has considered only the issues raised in paragraph 23 above and has not examined any other issue that may arise from the Facts of the Case, such as, propriety of preparation
of ‘Expenditure pending capitalisation Account’ upto 2006-07 and not the profit and loss account, accounting for expenditure incurred on AIBP, SCP, TSP, accounting for interest on short term investment of temporary surplus funds, etc.

25. With respect to nature of budgetary support received by the company, the Committee notes the definition of ‘Government grants’ from Accounting Standard (AS) 12, ‘Accounting for Government Grants’, which provides as follows:

“3.2 Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.”

From the above, the Committee notes that in the extant case, the budgetary support provided by the Government is assistance by the Government for meeting various kind of expenditures by the company. In this context, the Committee also notes that the querist has stated in the Facts of the Case that the company requests the Government for release of funds based on the budget allocation and the Government releases the same in the form of grant. Further, even though the term ‘budgetary support’ has been used in this query, the funds received from the Government are in the nature of grants only. Accordingly, relying on the above contentions of the querist and from the Facts of the Case, the Committee is of the view that the budgetary support provided by the Government is of the nature of government grant. Therefore, the principles of AS 12 can be applied in the extant case.

26. The Committee further notes that the budgetary support received from the Government can be broadly classified into the following categories:

I. Budgetary support received specifically for acquisition of a specific asset which are controlled by the company.

II. Budgetary support received for assets that are not controlled by the company, for example, the assets that are ultimately transferred to the Government/Government Departments.

III. Budgetary support for meeting specific revenue expenditure of the company.
IV. Budgetary support to support the activities of the company in general.

27. With regard to budgetary support received from the Government for specific asset, i.e., where the specific asset has been identified (either by the Government while providing the support or by the company while submitting the budget requirement to the Government), the issue to be examined is whether the company has the ability to exercise any ‘control’ on the asset created out of the expenditure incurred. In this context, the Committee notes the definition of ‘asset’ and paragraph 14 of Accounting Standard (AS) 26, ‘Intangible Assets’ notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the ‘Rules’) as follows:

“6.1 An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.”

“14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.”

From the above, the Committee notes that asset is a resource controlled by the enterprise and an enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. Accordingly, the Committee is of the view that it is only where the asset is controlled by the company in the manner envisaged by paragraph 14 of AS 26, the company should recognise asset in its financial statements in respect of the expenditure incurred. Further, with regard to budgetary support received from the Government for the assets that will be controlled by the
company, the Committee is of the view that in case such support is provided for the purchase, construction or acquisition of a specific asset, it should be recognized as ‘grant related to specific asset’ in accordance with paragraphs 8.1 to 8.4 of AS 12, notified under the Rules, 2006, reproduced below:

"8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

8.2 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

8.3 Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

8.4 Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after ‘Reserves and Surplus’ but before ‘Secured Loans’ with a suitable description, e.g., ‘Deferred government grants’.

28. With regard to the budgetary support received from the Government relating to assets that are not controlled by the company as envisaged by
paragraph 14 of AS 26, as discussed in paragraph 27 above, for example, the assets that are ultimately to be transferred to the Government/Government agencies/departments, the company should not recognise such assets in its financial statements in respect of the expenditure incurred. Further, with regard to the budgetary support in respect of such assets which are not controlled by the company, the Committee notes that in these cases, the company is merely incurring expenditure out of the budgetary support received and is holding the assets on behalf of the Government/Government agencies/departments. Therefore, the funds received from the Government to the extent not utilised for creation of the assets or for execution of the project represents an obligation on the part of the company and should be disclosed on the ‘Liabilities’ side in the balance sheet under a separate head, say the ‘funds received for projects/assets being constructed/executed on behalf of the Government/Government departments’. Further, the details of total funds received from the Government on this account, the funds utilised and the assets/project completed until transferred and capital work in progress (CWIP) should be provided in the notes to accounts to clearly explain the transactions.

29. With regard to the budgetary support received from the Government for meeting specific revenue expenditure of the company, the Committee notes the following requirements of AS 12:

“9.1 Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as ‘Other Income’. Alternatively, they are deducted in reporting the related expense.”

“15. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under ‘other income’ or deducted in reporting the related expense.”

From the above, the Committee is of the view that the budgetary support received from the Government for meeting specific revenue expenditure of the company should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate.
30. With regard to the budgetary support received to support the activities of the company in general and not with respect to any specific capital asset or revenue expenditure, the Committee is of the view that since these grants are not granted with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (as in case of grants of the nature of promoters’ contribution) or with reference to acquisition of a specific asset, such grant should be recognised as grants related to revenue in accordance with the requirements of paragraphs 9.1 and 15 of AS 12 as reproduced in paragraph 29 above.

31. In the background of the above discussion, the Committee is of the view that detailed information with regard to the type of budgetary support, whether it is for any specific project/asset and whether the expenditure results into creation of an asset controlled by the company, etc. is required to determine the accounting for any budgetary support. The Committee notes that such detailed information and facts pertaining to various budgetary supports received from the Government are not available in the extant case. For example, in case of budgetary support received for assets held for transfer to the Government/Government agencies, it is not clear whether these assets will be controlled by the company or not. Accordingly, the Committee is of the view that in respect of various budgetary supports received from the Government, viz., issues No. (i), (ii), (iii), (iv), (v) and (ix), as listed in paragraph 23 above, the company should determine as to whether these fall in category I, II, III or IV, viz., budgetary support received specifically for acquisition of specific assets which are controlled by the company, budgetary support received for assets that are not controlled by the company, budgetary support for meeting specific revenue expenditure of the company, or budgetary support to support the activities of the company in general, as discussed in paragraph 26 above and then accordingly, account for such budgetary support, as discussed in paragraphs 27 to 30 above.

32. With regard to the issue (vi) relating to accounting treatment of expenses incurred on rehabilitation and resettlement activity due to relocation of Bagalkottown through BTDA and rural R&R, where, as per the querist, the assets created will not be the assets of the company, the Committee notes that the querist has stated that the funding of the entire R&R activity is made by the company and that the expenditure incurred is part of and incidental to the overall project cost. With respect to capitalisation of
expenses, the Committee notes the following paragraphs from Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’:\(^2\):

“9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

(i) site preparation;

(ii) initial delivery and handling costs;

(iii) installation cost, such as special foundations for plant; and

(iv) professional fees, for example fees for architects and engineers.

The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.”

From the above, the Committee is of the view that R&R expenditure is normally incurred as a direct consequence of the project and though the R&R activity does not result into creation of any asset controlled by the company, it is directly attributable to the project. Accordingly, the Committee is of the view that expenditure on R & R activity should be capitalised as a part of the relevant project/assets provided the related assets/project in respect of which the R&R expenditure is being incurred is ‘controlled’ by the company and is accordingly, capitalised in the books of the company in accordance with the requirements of AS 10. However, in case the related asset/project is not ‘controlled’ by the company, the Committee notes from paragraph 28 above that in such cases, no asset would be recognised in its financial statements. Accordingly, the Committee is of the view that even the R&R expenditure incurred for such assets/projects out of the funds provided by the Government should be considered to be incurred on behalf of the Government as an executing/implementing agency. Therefore, the same

\(^2\)The opinion should be read in the context of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, which has been revised as AS 10, ‘Property, Plant and Equipment’ by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.
should not be recognised as an expense in the statement of profit and loss; rather the same should be adjusted against any budgetary support received for such R&R expenditure while disclosing the net amount as liability in the balance sheet, as discussed in paragraph 28 above. However, if any internal funds (for example, from internal accruals) are also utilised for such expenditure, the same should be recognised as an expense in the statement of profit and loss, since no asset ‘controlled’ by the company comes into existence.

33. With regard to the issue (vii) relating to treatment of expenses incurred on land acquisition for submergence under the dams, creation of canal systems, lift irrigation schemes, creating township, rehabilitation centres, staff colonies, roads and quarries for exploiting project construction material etc., the Committee notes that land is being acquired out of the capital grants and borrowed funds for various kind of assets, some of which would be transferred to the Government department/agencies and some of which may be retained by the company. The Committee further notes that the querist has stated that the land acquired by the company for project implementation is owned by the company and the company has control over the land being the owner. In this regard, the Committee is of the view that the ‘control’ over land should be determined in the context of paragraph 14 of AS 26, as reproduced in paragraph 27 above. The Committee is of the view that in case of lands acquired for creation of the assets which would ultimately be transferred to the Government departments/agencies on completion of their construction, such as roads, townships, rehabilitation centres, etc., ordinarily, the company would not possess ‘control’ over such lands after transfer and as such, in these cases, land should not be recognised as an asset of the company. In such cases, the expenditure incurred on land acquisition shall be considered to be incurred on behalf of the Government. Therefore, the same should be deducted from any budgetary support received for such land acquisition while disclosing the net amount as liability in the balance sheet, as discussed in paragraph 28 above. In such cases, if the expenditure is being incurred out of the internal funds (for example, from internal accruals), the same should be recognised as an expense in the statement of profit and loss. However, in cases where the company possesses ‘control’ over such lands as discussed above, the same should be recognised as ‘asset’ of the company.

34. With regard to the issue (viii) relating to accounting treatment of creation of field irrigation canals (FICs) in the farmers’ fields by the Command Area
Development Authority (CADA) from the funds provided by the company which do not belong to the company, the Committee notes that the querist has stated that the field irrigation canals are created for carrying water from canal outlet upto the farms and fields and that without the field irrigation canal, water cannot be put to use by the farmer. Further, it has also been stated that the objective of creating field irrigation canals is to bridge the gap between the irrigation potential created at the outlet and that utilised and that the project is fully complete if water is used by farmers through the irrigation facilities created. Thus, FICs created out by CADA from funds provided by the company is critical to the irrigation project. In this regard, the Committee also notes that the FICs in the farmers’ fields do not belong to the company. However, it is not clear whether these are ‘controlled’ by the company in the manner envisaged in paragraph 14 of AS 26, as discussed in paragraph 27 above. The Committee is of the view that if these are ‘controlled’ by the company and meet the definition of ‘asset’, these can be recognised as separate assets in the books of account of the company. However, if FICs are not controlled by the company, the Committee further notes paragraph 9.1 of AS 10, as reproduced in paragraph 32 above and the following paragraphs of AS 10, notified under the Companies (Accounting Standards) Rules, 2006:

“10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.”

“21. The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.”

From the above, the Committee is of the view that the basic principle to be applied while capitalising an item of cost to the cost of a fixed asset/project is that it should be directly attributable to the construction of the project/ fixed asset for bringing it to its working condition for its intended use. The costs that are directly attributable to the construction/acquisition of a fixed asset/project for bringing it to its working condition are generally those directly related costs that would have been avoided if the construction/
acquisition had not been made. These are the expenditures without the incurrence of which, the construction of project/asset could not have taken place and the project/asset could not be brought to its working condition, such as, site preparation costs, installation costs, salaries of engineers engaged in construction activities, etc. Accordingly, the Committee is of the view that in case, expenditure on FICs does not result into creation of a separate ‘asset’ for the company, such expenditure can still be capitalised with the cost of the related irrigation project being capitalized by the company provided such expenditure is directly attributable to the related irrigation project, as discussed above. In case such expenditure is not directly attributable to the irrigation project, the same should be charged to the statement of profit and loss to the extent such expenditure is being incurred out of the internal funds (for example, internal accruals). However, if the expenditure is being incurred out of the funds provided by the Government, the expenditure incurred to such an extent should be adjusted against the budgetary support received from the Government.

35. With regard to the issue (x) relating to treatment of interest payment on long term loans/bonds etc. in respect of capital projects/capital expenses incurred, the Committee notes the following relevant accounting principles related to borrowing costs as provided under Accounting Standard (AS) 16, ‘Borrowing Costs’, notified under the Rules, as follows:

“3.2 A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.”

“6. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.”

“8. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.”
“12. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.”

“14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;
(b) borrowing costs are being incurred; and
(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.”

From the above, the Committee notes that the borrowing costs can be capitalised as a part of the cost of a qualifying asset only when expenditure for the acquisition, construction or production of qualifying asset is being incurred and other conditions of paragraph 14 of AS 16, as reproduced above are fulfilled. Further, only the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as a part of the cost of that asset. The Committee further notes from the Facts of the Case that the querist has stated that borrowings are not project specific and the borrowings are generally to be used for all the projects being implemented by the company. Further, it is also stated that the utilisation of the funds borrowed cannot be related to a particular work and the funds are released to project offices for making payments out of pooled funds i.e., grants received from the Government, borrowed funds and internal accruals. In this regard, the Committee notes from paragraph 12 of AS 16 that to the extent that funds are borrowed generally, (i.e., without specifying any particular project) and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation
rate to the expenditure on that asset. The Committee is of the view that in the
extant case, since the company raised loans for various projects in
general and the payment for the project is being made out of the pooled
funds comprising of loans, internal accruals, etc. it may be difficult to identify
exact amount of borrowing funds utilised for a particular project. However,
determining to what extent general borrowings have been used for a specific
project, is a question of fact and should be determined by exercising the
best judgement considering various factors, for example, information related
to cash inflows and outflows. Accordingly, the Committee is of the view that
the company should determine the borrowing cost, if any, to be capitalised
as a part of the project cost as discussed above. The balance interest cost,
if any, should be charged to the statement of profit and loss. In this context,
the Committee also wishes to point out that the borrowing costs to be
capitalised with the project cost should be net of the related budgetary
support, received, if any.

D. Opinion

36. On the basis of the above, the Committee is of the following opinion
on the issues raised in paragraph 23 above:

(i), (ii), (iii), (iv), (v) and (ix) - The company should determine as to
whether these fall in the category I, II, III or IV, as listed in paragraph
26 above, viz., budgetary support received specifically for acquisition
of specific assets which are controlled by the company, budgetary
support received for assets that are not controlled by the company,
budgetary support for meeting specific revenue expenditure of the
company, or budgetary support to support the activities of the company
in general, as discussed in paragraph 26 above and then accordingly,
account for such budgetary support, as discussed in paragraphs 27 to
30 above

(vi) Refer paragraph 32 above.

(vii) Refer paragraph 33 above.

(viii) Refer paragraph 34 above.

(x) Refer paragraph 35 above.
Query No. 13

Subject: Accounting treatment of dead stock.

A. Facts of the Case

1. A company is a joint venture of N Ltd. and G Ltd., engaged in the business of electricity generation and LNG (Liquefied Natural Gas) regasification having facility at Anjanwel, Maharashtra.

2. The company has commissioned its LNG regasification unit (LNG Terminal) on 22nd May, 2013. The querist has stated that for commissioning of the LNG Terminal, the company has procured one time LNG which is required to be maintained at minimum level in the system comprising of ring main and storage tanks to keep the LNG Terminal operational. LNG is stored in the LNG storage tanks at (-) 162 °C. The minimum level of LNG is required to be maintained for operation of the pump and to keep the tank in cold condition to avoid expansion/contraction for life time. The boil off gases from the top layer of LNG is removed to avoid pressure increase of the tanks and maintaining the cold condition.

3. The querist has further stated that the company has entered into long term agreement with G Limited to provide services of regasification of LNG brought by them through its LNG Terminal against the predefined charges (per MMBTU) as per the agreement. Separate inventory records of the company and G Ltd. are maintained and reconciled quarterly, although physical separation of inventory of the company and G Ltd. is not possible. The querist has also stated that the company has no obligation for procurement of LNG cargos and related expenditure. G Ltd. has allowed system use gas of 0.66% of received energy and any gas consumption for system use other than fuel gas is charged to consumption. The company has to maintain the minimum LNG level including by replenishment although may be rarely required during the lifetime of the plant operations. The company has contractual arrangement with GLtd. to bring cargos so as to maintain cold conditions of the plant.

4. According to the querist, it is pertinent to mention that LNG in the ring main and storage tank, procured at the time of commissioning by the company, is essential minimum quantity of LNG which is pre-requisite for keeping the LNG Terminal ready for operation at any time and it cannot be

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1 Opinion finalised by the Committee on 11.1.2016.
taken out from the system except in the case of decommissioning of the plant when it has to be released in the atmosphere. In view of the above, the company has capitalised the cost of LNG required to keep the system operational along with the LNG Terminal.

Basis of treatment given by the company

5. The querist has also stated that the company has capitalised the LNG based on paragraph 6.1 of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’ which provides that “Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.” Further, while capitalising the cost of LNG, the company has considered the following:

(i) The LNG stock in question is minimum essential to keep the LNG terminal operational and cannot be taken out from the system even in the case of decommissioning of the plant.

(ii) The LNG in the ring main is pre-requisite for keeping the LNG Terminal available for uninterrupted re-gasification services as per the agreement with G Ltd.

(iii) The company is only providing services for regasification of LNG bought by G Ltd. under the agreement and not in the business of sale or purchase of LNG in normal course.

6. With regard to the process being followed at LNG regasification unit (LNG Terminal) and the company’s relationship with G Ltd., the querist has separately clarified as follows:

(i) LNG is unloaded at jetty from the ships and transferred to LNG tanks through pipelines called ring main. Complete ring main system and LNG tanks are required to be maintained in cold chain at (-) 160°C by the removal of heat in form of boil off gases produced from evaporation of LNG itself and by circulation of LNG in the ring main. The maintenance of cold chain is essential in ring main pipelines throughout the plant life, otherwise

\[\text{\footnotesize \textsuperscript{2}}\text{The opinion should be read in the context of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets, which has been revised as AS 10, ‘Property, Plant and Equipment’ by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.}\]
with the heat ingress leading to temperature differentials, the pipelines would bend due to thermal expansion and crack leading to release of hazardous hydrocarbons in cryogenic conditions. Similarly, the LNG tanks also need to be maintained at (-) 160°C for avoiding major damages to tanks because of thermal expansions–contractions effects. In case of breakage of cold chain, the plant would require safe decommissioning and would require re-commissioning with huge expenditure and uncertainty of pipeline and tank integrity. This cold chain is to be maintained even if ships are not coming to LNG terminal. For this purpose, during project design of LNG terminal, the distance between jetty and tanks is minimised so that cold chain can be maintained easily.

(ii) To keep the LNG Terminal operational and in cold conditions as explained above, it is mandatory to maintain the essential minimum quantity of LNG in the ring main and storage tanks. This quantity of LNG can never be used in the life cycle of the plant as this cannot be pumped out and required to be always present in the system to keep the terminal operational. Even in the case of decommissioning this quantity cannot be used or sold except to be flared up in the atmosphere.

(iii) The company has appointed G Ltd. as commercial operator of the terminal on tolling basis. G Ltd. purchases and brings the LNG ships at the company’s terminal and role of the company is limited to re-gasify the liquid and supply the gas to the G Ltd. cross country pipelines. The company charges re-gas services based on energy equivalent re-gasification.

The company brought the minimum essential quantity of LNG required for cold chain maintenance of ring main and LNG tanks to keep LNG Terminal operational at the time of commissioning and maintains its accounts separately from G Ltd.’s stocks. Although it is not possible to keep them separate physically but the average composition of minimum essential quantity LNG will largely remain same as temperature and pressure are maintained.

The querist has also supplied a flow chart to explain the process at Annexure I.
B. Query

7. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the company has given correct treatment by capitalising the cost of LNG required essentially for keeping the system operational and available for uninterrupted regasification services to G Ltd. under the agreement.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to the accounting treatment of the cost of the minimum level/quantity of LNG required to be maintained in the system, viz., LNG Terminal comprising ring main (pipelines) and storage tanks. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for regasification services provided by the company to G Ltd., valuation of inventory of gas in the system, determination of cost of gas, etc.

9. With regard to the issue raised, the Committee notes the definition of the term ‘inventories’ as given in Accounting Standard (AS) 2, ‘Valuation of Inventories’, and the definition of the term ‘fixed asset’ as given in Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, notified under the Companies (Accounting Standards) Rules, 2006, which are reproduced below:

AS 2

“3.1 Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.”

AS 10

“6.1 Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.”

10. From the above, the Committee notes that the classification of an asset as a fixed asset or inventory depends on its intended primary use for
an entity. If an asset is essentially held for using it for the purpose of producing or providing goods or services rather than for sale in the normal course of business, it is classified as fixed asset. However, if it is held for sale in the ordinary course of business, or if it is used in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services, the asset should be classified as inventory. The Committee notes from the Facts of the Case that complete ring main system and LNG tanks are required to be maintained in cold chain at (-) 160°C. The maintenance of cold chain is essential in ring main pipelines throughout the plant life, otherwise with the heat ingress leading to temperature differentials, the pipelines would bend due to thermal expansion and crack leading to release of hazardous hydrocarbons in cryogenic conditions. Similarly, the LNG tanks also need to be maintained at (-) 160°C for avoiding major damages to tanks because of thermal expansions–contractions effects. Further, in case of breakage of cold chain, the plant would require decommissioning and this cold chain is to be maintained even if ships are not coming to LNG terminal. For this purpose, during project design of LNG terminal, the distance between jetty and tanks is minimised so that cold chain can be maintained easily.

11. From the above, the Committee notes that minimum quantity of LNG in the ring main and storage tanks is essential to maintain the temperature so as to avoid expansion/contraction of the ring main and storage tanks and to keep the LNG Terminal operational. Thus, minimum level of LNG in the ring main and storage tank is pre-requisite for keeping the LNG Terminal (plant) ready for operation at any time. Accordingly, the Committee is of the view that in the extant case, technological design of pipelines and tanks is such that, minimum level of gas is always required to be maintained in the system to keep the system operational and that such pipelines and tanks are not merely a mode of transportation and storage. The Committee also notes that the company is only providing services for regasification of LNG bought by G Ltd. under the agreement and not in the business of sale or purchase of LNG in normal course. Thus, it is not held for sale in the normal course of business. Further, it is noted from the Facts of the Case that this quantity of LNG can never be used in the life cycle of the plant as this cannot be pumped out and required to be always present in the system to keep the Terminal operational. Even in the case of decommissioning this quantity cannot be used or sold except to be flared up in the atmosphere. Thus, it cannot also be considered to be held for sale or consumption in the process of production or in the rendering of services. Accordingly, the
Committee is of the view that the minimum level of gas cannot be considered and recognised as ‘inventory’. The Committee is of the view that the cost of initial gas procured for commissioning of the LNG Terminal should be recognised as a fixed asset.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the treatment given by the company of capitalising the cost of LNG required for keeping the system operational is appropriate.
Query No. 14

Subject: Treatment of expenditure incurred by the company on roads for transportation of coal.\(^1\)

A. Facts of the Case

1. A company (hereinafter referred to as ‘the company’) was incorporated under the Companies Act, 1956 on 3\(^{rd}\) April, 1992 after taking over of assets and liabilities of a company, S Limited in respect of mines in the state of Orissa. 100% of its equity is held by another company, C Ltd. and its nominees. The main objective of the company is to produce coal and its sale/despatch to various customers.

2. The querist has stated that during the year 2014-15, the company had revenue from operations of Rs. 11668.48 crore and profit before tax was Rs. 5314.24 crore. The balance sheet as at 31.03.2015 and profit and loss statement for the year 2014-15 has been supplied by the querist for the perusal of the Committee. It has 10 (ten) operating areas and each area is having number of mines. Most of the mines are open cast mines. One area Basundhara is situated in Sundargarh district, Orissa, which is very remote and 40 k.m. away from district city Sundargarh. It has no railway connectivity. This area has at present two operating mines Basundhara (West) open-cast and Kulda open-cast having last year’s (2014-15) production of 37.23 lakh tonnes and 48.04 lakh tonnes, respectively. The surrounding areas are coal bearing and having huge future prospects. Siarmal and Garjanbahal are future approved projects in this area having projected annual production of 400 lakh tonnes and 100 lakh tonnes respectively. The rail connectivity between Jharsugada and Sardega (Basundhara area) is under construction.

3. The querist has further stated that due to non-availability of rail connectivity, despatch is done through road transport to nearest Kanika railway siding which is around 27 k.m. away from mines. The existing two lane road from Banki Bahal to Kanika railway siding through which coal is transported, is also extensively used by local villagers for transportation/communication purpose. This mixed traffic of local people with cycles, motor cycles, four wheelers, etc. along with coal loaded trucks and dumpers is causing inconvenience, traffic jams and is also causing regular accidents due to which blockage of roads and damage of vehicles are common

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\(^1\) Opinion finalised by the Committee on 11.1.2016.
phenomena in this road. The average coal transportation from mines of basundhara area is approximately 18000 tonnes per day. In future, there will be more coal transportation to liquidate more production. Hence, there was a business necessity and compulsion to widen this road to liquidate the coal stock and to maintain continuity of production. This road belongs to Works Department of the State Government. To find a solution to the management problem of transporting the coal, the company had a MOU dt. 07.05.2013 with the Works Department, Government of Odisha, for widening of two lane road to four lane from Banki Bahal to Kanika railway siding and for construction of two other roads.

4. The querist has also stated that the District Collector vide order dt. 12.08.2013 restricted movement of commercial vehicles from Banki Bahal to Kanika siding from 9 AM to 5 PM in compliance of order of Hon'ble High Court of Odisha dt. 12.07.2013. Further, the High Court directed to construct four lane road from Banki Bahal to Kanika Siding to avoid traffic congestion.

5. Accounting policies of the company for booking of development and prospecting and boring are enumerated below:

(1) Development:

Expenses net of income of the projects/mines under development are booked to Development Account and grouped under capital work-in-progress till the projects/mines are brought to revenue account. Except otherwise specifically stated in the project report to determine the commercial readiness of the project to yield production on a sustainable basis and completion of required development activity during the period of construction, projects and mines under development are brought to revenue considering the following criteria:

(a) From beginning of the financial year immediately after the year in which the project achieves physical output of 25% of rated capacity as per approved project report, or

(b) 2 years of touching of coal, or

(c) From the beginning of the financial year in which the value of production is more than total expenses.

Whichever event occurs first.
(2) Prospecting & Boring and other Development Expenditure:

The cost of exploration and other development expenditure incurred in one ‘Five year’ plan period will be kept in capital work-in-progress till the end of subsequent two ‘Five year’ plan periods for formulation of projects, before it is written-off, except in the case of blocks identified for sale or proposed to be sold to outside agency which will be kept in inventory till finalisation of sale. Prospecting, boring and development expenditure are amortised from the year when the mine is brought under revenue in 20 years or working life of the project whichever is less.

6. The querist has also stated that based on the Memorandum of Understanding (MOU) with Works Department and since this is a deposit work, the company’s management approved an estimate for widening of two lane road to four lane from Banki Bahal to Kanika railway siding (25.75 k. m.) for Rs. 266.50 crore with an instruction that the related expenditure to be booked under ‘Intangible Assets’ to be amortised every year. Accordingly, the deposits made to Works Department as per MOU during the year 2014-15 amounting to Rs. 39.43 crore was shown as ‘Intangible Assets under construction’ - Note 10(C) forming part of balance sheet (line item – Development) as at 31.03.2015. As per article 2.7 of the MOU, after completion of the projects, the roads shall be maintained by the company. While approving the proposal, it was observed by the management that neither the land to be acquired for widening the road nor the road will be the property of the company and these will remain the property of the Works Department, Government of Odisha with the company’s responsibility to maintain the road as per MOU. The proposed deposit work will facilitate unrestricted movement of coal laden trucks (in terms of timing) and the nearby villagers will also be beneficiaries.

7. During supplementary audit conducted by the Comptroller and Auditor General of India (CAG) under section 143(6) of the Companies Act, 2013, the booking of expenditure incurred during the year 2014-15 and its debit to intangible asset under construction were questioned and the management gave an assurance to CAG that the related matter would be referred to the Institute of Chartered Accountants of India for its perusal and valued opinion.

8. According to the querist, the management debited this expenditure to intangible asset on reasoning that the benefit of this expenditure will accrue to the entity for periods beyond one year and by MOU, the company gets an unrestricted right to use this asset by incurring annual running repair and
maintenance expenditure. The future running repair and maintenance expenditure will be booked to revenue account to get a fair view of profit for the years.

B. Query

9. Based on the facts and the analysis as above, the querist has sought the opinion of the Expert Advisory Committee on the treatment of above expenditure.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to whether expenses incurred for widening of two lanes road to four lanes road, which is not owned by the company can be recognised as intangible asset. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, propriety of accounting policy for development, prospecting and boring expenses, accounting treatment of expenses on coal blocks, treatment of future running repair and maintenance expenditure incurred on roads, etc.

11. The Committee notes from the Facts of the Case that the company has two operating mines in Basundhara Area, from where the company produces coal for its sale/despatch to various customers. However, due to non-availability of rail connectivity, despatch of coal is done through road transport (two lane road), where there is some restriction of movement of commercial vehicles. Therefore, the company has entered into an MoU with the Works Department, Govt. of Odisha, for widening of the existing two lanes to four lanes. As per the querist, in future, there will be more coal transportation to liquidate more production and hence, there is business necessity and compulsion to widen this road to liquidate the coal stock and to maintain continuity of production. However, the land on which the road is situated and the road will be the property of the Works Department, Government of Odisha. Now, the issue is whether expenses incurred for widening of two lanes road to four lanes road can be recognised as intangible assets in the books of the company. In this context, the Committee notes the following paragraphs from AS 26:

"6.1 An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes."
6.2 An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.”

“14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. ...”

From the above, the Committee notes that an expenditure incurred by an enterprise can be recognised as an asset only if it is a ‘resource controlled by the enterprise’. Thus, it is the control over the resource that is important for recognising an expenditure as an asset. The Committee further notes that as per paragraph 14 of AS 26, an enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. In this regard, the Committee notes from the Facts of the Case that the neither the land to be acquired for widening the road nor the road will be the property of the company. These will remain the property of the Works Department, Government of Odisha, with the company’s responsibility to maintain the road as per the MOU. Further, it is noted that the querist has stated that the nearby villagers will also be beneficiaries. From this, it appears that although the work of widening the road will facilitate unrestricted movement of coal for the company, the company does not enjoy control in terms of restriction of access of others to the benefits arising from the widened road facility. Therefore, the Committee is of the view that the expenditure incurred on widening and construction of road on the land which is not owned by the company does not meet the definitions of the terms ‘asset’ and ‘intangible asset’. Accordingly, such expenditure cannot be capitalised as an intangible asset.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that that the expenditure incurred for widening of two lanes road to four lanes road cannot be capitalised as an intangible asset, as discussed in paragraph 11 above.
Query No. 15  

Subject: Accounting treatment for the project assets under construction.¹

A. Facts of the Case

1. The Sardar Sarovar Project (SSP) is a collaborative effort between four states, viz., Gujarat, Maharashtra, Madhya Pradesh and Rajasthan (collectively referred to as Party states). On reference by the Government of Gujarat (GOG), the Central Government (‘CG’) constituted Narmada Water Disputes Tribunal (NWDT) in October, 1969, under the provisions of section 4 of the Inter-State River Water Disputes Act, 1956 to settle the disputes between the Party States. The project report of SSP prepared by GOG was submitted to Central Water Commission (CWC) for clearance. Narmada Water Scheme, 1980 was published in Gazette on 10-09-1980 by the Government of India (GOI). Narmada Control Authority (NCA) started functioning in December, 1980. As per the NWDT order, the GOG was given the primary responsibility for the execution of the project.

2. The querist has stated that to comply with NWDT order and with specific objective to execute the SSP, the GOG incorporated a company (hereinafter referred to as ‘the company’), as a wholly owned Government company under the Companies Act, 1956 as per the Government Resolution (‘GR’) dated 21st March, 1988, passed by the Government of Gujarat. The relevant extracts of the NWDT order have been provided by the querist for the perusal of the Committee.

3. On formation of the company, the Government of Gujarat, Narmada Development Department vide Resolution dated 31st March, 1988 transferred en-bloc the entire staff and officers of the circles and other heads etc. working under the control of Narmada Development Department to the company. Further, the Government of Gujarat also transferred assets of Sardar Sarovar Narmada Project to the company vide G.G. No. COR-1488-H dated 27 October, 1988. The value of the assets transferred was tentatively fixed at Rs. 533.09 crore at the prices prevailing in the year 1988 for which the valuation was finalised at the same amount vide GR No. PARCH/2013/1323/74/N dated 10 July 2015. In consideration for the transfer of assets, equity shares were issued to Government of Gujarat.

¹ Opinion finalised by the Committee on 1.2.2016.
Brief of SSP assets and project status as on date

4. The querist has further stated that SSP envisaged by the company can be divided into three broad parts:

(i) Power Plants – Eleven (11) hydro power stations consisting of six units of canal head power houses (CHPH) and five units of river bed power houses (RBPH)

(ii) Water Project – comprising of branch canals, distributaries, minors and sub minors

(iii) Common Assets – consisting of dam and main canal

5. The querist has also stated that while the work on SSP commenced in 1980, work on some portions is still in progress. The project status for each of the segments identified as on 31\textsuperscript{st} March, 2015 is as under:

(i) Power Plants - The company started generation of electricity during F.Y. 2004-05 and all the five units of CHPH and six units of RBPH have been functioning since then. Generation of power mainly depends upon the reservoir level which is determined by the height of dam. At dam height of 138.68 meters, the power can be generated to 6343 MU. While at present dam height of 121.92 meters, the power is generated to the tune of 3600 MU. Thus, the additional 2743 MU, i.e., 43.25% is yet to be generated against the planned capacity. The full reservoir storage capacity will be reached only after the installation of gates.

(ii) Water Project - The water project comprises of branch canals, distributaries, minors and sub minors. The physical work done in respect of canal network as on 31\textsuperscript{st} March, 2015 is given under Table 1 below.

(iii) The Dam and Main Canal - The Sardar Sarovar Dam has reached the spillway crest level, i.e., EL 121.92 meters on December 31, 2006. At this stage about 96% of the total concrete work has been completed. The live storage capacity at full reservoir level (FRL) 138.68 meters is 5760 million cubic meter (MCM), whereas at the dam height of 121.92 meters, the live storage capacity is of 1565.84 MCM which is 27.18% of the total live storage capacity.
6. The construction of entire 458 Km length of concrete lined Narmada Main Canal (NMC) within Gujarat is completed. The water of Narmada is being released to Rajasthan State since March 2008 through Narmada Main Canal. In nutshell, at the present height of EL 121.92 of dam and Main Canal having completed its intended length of 458 Kms, the power plants are functioning at the level of not at the intended capacity, moreover the other irrigation network has been completed at a level which does not give 100% of its anticipated capacity but are functioning at sub-optimum level.

The table below summarises % of completion status as on 31st March, 2015 for various components of SSP:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Particulars</th>
<th>Achieved till date 31.03.15</th>
<th>Target</th>
<th>% completion</th>
<th>Parts as identified under section B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Power generation capacity – MU</td>
<td>3,600</td>
<td>6,343</td>
<td>56.76</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>No. of Power Plants</td>
<td>11</td>
<td>11</td>
<td>100.00</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Branch Canal – KMs</td>
<td>2,585</td>
<td>2,585</td>
<td>93.15</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Branch Canal – Nos.</td>
<td>38</td>
<td>38</td>
<td>97.36</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Distributaries – KMs</td>
<td>5,112</td>
<td>5,112</td>
<td>71.53</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Minors – KMs</td>
<td>18,413</td>
<td>10,222</td>
<td>55.52</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Sub Minors – KMs</td>
<td>48,058</td>
<td>10,444</td>
<td>21.73</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Irrigation potential – Lac hectares</td>
<td>17.92</td>
<td>11.11</td>
<td>62.00</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Live storage capacity @MCM</td>
<td>5,760</td>
<td>1,565.84</td>
<td>27.18</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Dam Height – meters</td>
<td>138.68</td>
<td>121.92</td>
<td>87.91</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>Main Canal – KMs**</td>
<td>458</td>
<td>458</td>
<td>100.00</td>
<td></td>
</tr>
</tbody>
</table>

**certain structures are still remaining to be constructed.

Notes:
- Against the targeted Culturable Command Area (CCA) of 17.92 lac hectare to be developed, 3.70 lac hectare (21%) has been developed till March 31, 2015.
Against the targeted irrigation potential of 17.92 lac hectare to be created, 11.11 lac hectare (62%) has been created till March 31, 2015.

Present accounting policy with respect to capitalisation

7. The querist has also reproduced the present accounting policy adopted by the company as below and duly disclosed in the annual accounts of the company for the financial year (F.Y.) 2013-14. The querist has also mentioned that the accounting policy was approved in the meeting of the board of directors (BOD) held on 25th June, 2009 and it was also decided to continue with the accounting policy and treatments for F.Y. 2008-09 and onwards and hence, the company has continued the same accounting policy and accounting treatment for F.Y. 2011-12 to F.Y. 2013-14. The said financial years have been duly approved in the same manner in the BOD meeting held on 22.11.12, BOD meeting held on 11.09.13 and BOD meeting held on 27.11.14, respectively. The company has also continued the same accounting policy and treatment for F.Y. 2014-15:

“6(d) Till the substantial completion of the project, all the direct expenditure incurred on the works are treated as Capital Work in Progress. All the indirect expenditure incurred in respect of such structures, Canals and Power Houses including its operational income and expenditure are stated under ‘Incidental Expenditure Pending Capitalisation’. Balance of ‘Incidental Expenditure Pending Capitalisation’ will be apportioned to the various components of the project on substantial completion of the project.”

8. Project will be considered as ‘substantially’ completed on satisfaction of the following two conditions together:

(i) Achievement of 15.23 lac hectares, being 85% of 17.92 lac hectares of the land contemplated for irrigation potential; and

(ii) Physical completion of dam and other allied components including power houses.

Further, the company has taken a view that being incorporated specifically for the purposes of execution of the SSP, its existence is limited to completion of the said objective. Considering the provisions of the NWDT order, it would not be incorrect to consider the company as an agency for execution of the project and not the owner of the same.
Compendium of Opinions — Vol. XXXV

The querist has also reproduced the net block of fixed assets as on March 31, 2015 (unaudited) as under:

Table 2

<table>
<thead>
<tr>
<th>Fixed Assets</th>
<th>Amount in Rs. (crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible Assets</td>
<td>3,659.64</td>
</tr>
<tr>
<td>Intangible Assets</td>
<td>0.77</td>
</tr>
<tr>
<td>Capital work-in-progress**</td>
<td>43,108.64</td>
</tr>
<tr>
<td>Intangible assets under development</td>
<td>2.53</td>
</tr>
<tr>
<td>Incidental Expenditure pending capitalisation</td>
<td>(1,321.81)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>45,449.77</td>
</tr>
</tbody>
</table>

**Capital work-in-progress consists of major assets as follows as on March 31, 2015:

<table>
<thead>
<tr>
<th>Capital Work-in-progress</th>
<th>Unaudited Amount in Rs. (crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dam &amp; Appurtenant works</td>
<td>7,761.11</td>
</tr>
<tr>
<td>Main Canal</td>
<td>8,503.19</td>
</tr>
<tr>
<td>Power</td>
<td>5,063.02</td>
</tr>
<tr>
<td>Branches &amp; Distributaries</td>
<td>21,780.05</td>
</tr>
<tr>
<td>Buildings &amp; others</td>
<td>125.31</td>
</tr>
<tr>
<td>Stock of Construction materials, stores &amp; spares</td>
<td>0.07</td>
</tr>
<tr>
<td>Less: Receipts &amp; Recoveries</td>
<td>(124.11)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>43,108.64</td>
</tr>
</tbody>
</table>

9. The company’s contention for each segment, as identified, is as follows:

(i) **Power Project** - Hydro power project is functioning at sub-optimal level at the present dam’s height of 121.92 meters considering
the fact that the live storage capacity achieved is of only 27.18% as compared to that of at the full height of 138.68 meters. Though the company started generation of electricity during F.Y. 2004-05 and all the five units of CHPH as well as six units of RBPH are functioning, the generation of power mainly depends upon the reservoir level which is determined by the height of dam. The potential of power generation for additional 2743 MU i.e., 43.25% is yet to be achieved at the full height of the dam. Therefore, the power project and dam have not been completed ‘substantially’ (emphasis supplied by the querist).

(ii) **Water Project** – With reference to table 1 above, while the targeted irrigation potential of 17.92 lac hectare is to be created at the full height of the dam, only 11.11 lac hectare (being 62%) has been created till 31st March, 2015. Therefore, the water project is also not substantially completed as on 31st March, 2015.

(iii) The whole SSP is under implementation and the identifiable components should not be seen in isolation as they are interdependent and interlinked with one another. The concept of completion as envisaged in Accounting Standard (AS) 10 implies completion of substantially all the material activities attributing to the qualifying assets. As per the accounting policy followed by the company consistently, the substantial completion of at least 85% of project components should be viewed in totality. Date of substantial completion is prerequisite for date of commissioning for commercial operation.

(iv) The company has referred the matter to the Finance Department of Gujarat with respect to present accounting policy and the Department suggested to continue the same treatment.

10. The querist has also reproduced the observations/comments from the auditors and response of the management as follows:
<table>
<thead>
<tr>
<th>Summary of observations and comments</th>
<th>Summary of management responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory auditors have been qualifying/commenting the accounting policy and treatment adopted by the company since F.Y. 2007-08.</td>
<td>The management presented as under:</td>
</tr>
</tbody>
</table>

  * SSP is an integrated project having interdependent and interlinked components and is still under execution. It is not substantially completed as on balance sheet date. |

  * The company was incorporated for the purposes of execution of the SSP and in terms of the object clause as well as the provisions of the NWDT order, there is no provision to own the project. |

  * SSP being a socio-economic project, the company is not an entity carrying on commercial or business activities and hence, accounting standards are not applicable. |

  * Management is of the view that it is not possible to arrive at an allocation of the common expenses and ascertain the amounts of rehabilitation & resettlement, forest & environment expenses and other indirect cost of various components required to be capitalised. |
B. Query

11. On the basis of the facts and circumstances stated above, the company has sought the opinion of the Expert Advisory Committee on the following accounting issues:

- Based on the allocation of the revenue and cost for various components as suggested by the NWDT order, it would not be prudent to capitalise full cost based on the matching concept.

- It is in line with the direction of the Finance Department, Department of Gujarat, as mentioned above. Detailed responses have been enumerated in the Annual Report of the company, which has been provided by the querist for the perusal of the Committee.

C&AG auditors have commented on non-capitalisation of power houses until F.Y. 2009-10. Post that, until F.Y. 2012-13, they have commented on non-capitalisation of the dam, main canal and parts of branches and distributaries in addition to power houses. They also emphasised on quantification of amounts involved. The querist has provided extracts of C&AG qualification for the perusal of the Committee.

The company has referred the matter to Finance Department of Gujarat, as mentioned above. The accounting policy as suggested there in has been followed.
(i) Whether the present accounting policy followed by the company and the accounting treatment of non-capitalisation of the SSP in its books of account on the grounds that the entire SSP is not ‘substantially’ ready for its intended use, is in accordance with generally accepted accounting principles in India.

(ii) If the answer to above query (i) is negative, should the SSP be broken into units of accounts (UOA), viz., (1) Power Plants (2) Water Projects and (3) Common Assets, with each part being evaluated for capitalisation under the guidance of generally accepted accounting principles in India?

(iii) If the answer to above query (ii) is yes, would it be correct to capitalise the identified units of accounts at their present stage of completion considering the fact that they are functioning at sub optimal capacity as compared to the intended full capacity? Whether subsequent expenditures would be evaluated for capitalisation based on the provisions enumerated under AS 10.

(iv) If the answer to above query (ii) & (iii) is yes, then would it be correct to consider dam and main canal as common assets for the purpose of capitalisation of SSP, the cost being allocated on the basis of allocation specified under Clause XII of the NWDT Order? If no then, what would be an appropriate basis for the purposes of allocation of the cost?

C. Points considered by the Committee

12. The Committee notes that the basic issue raised in the query relates to propriety of accounting policy of the company of recognising various items of expenditure incurred on the SSP as ‘Capital Work-in-Progress’. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, treatment of different items of costs (direct and indirect) which may be eligible for capitalisation as per the principles of AS 10 as the details pertaining to these expenditure have not been provided by the querist, non-preparation of the statement of profit and loss by the company till substantial completion of the Project, interpretation of the NWDT order, etc. The Committee further wishes to point out that the extent of readiness of intended full capacity of SSP, depending on technological evaluation of the project, has not been examined by the Committee.
13. At the outset, the Committee notes from the Facts of the Case that the querist has stated that the company being incorporated specifically for the purposes of execution of the SSP, its existence is limited to completion of the said objective and considering the provisions of the NWDT order. Thus, it would not be incorrect to consider the company as an agency for execution of the project and not the owner of the same. In this regard, the Committee wishes to point out that on formation of the company, the assets of the Narmada Development Department were transferred to the company and in consideration of that, equity shares were issued to the Government of Gujarat. Further, it is also observed from the Annual Report of the company that time and again shares have been issued to the Government of Gujarat. The Committee also notes that at present also, the company is recognising the expenditure incurred on project as ‘capital work-in-progress’ and shall capitalise the same in its financial statements as and when the project is substantially complete as per the company. From the above, it appears to the Committee that the project being undertaken by the company is controlled by the company that can be capitalised in its books.

14. The Committee further notes that the querist has further contended that SSP being a socio-economic project, the company is not an entity carrying on commercial or business activities and hence, accounting standards are not applicable. In this regard, the Committee wishes to point out that the company being incorporated under the provisions of Companies Act, all provisions including the provisions related to compliance with the Accounting Standards notified under the Companies Act shall be applicable to it unless specifically exempted.

15. With regard to the issue raised by the querist, the Committee notes from the Facts of the Case that at present, the dam has reached the spillway crest level, i.e., EL 121.92 meters and the power is generated to 3600MU whereas at the targeted/planned dam height of 138.68 meters, the power can be generated at 6343MU. Thus, the balance 2743MU is yet to be generated against planned capacity. Further, targeted irrigation potential of 17.92 lac hectare is to be created at full height of dam (viz., 138.68 meters), whereas only 11.11 lac hectare (being 62%) has been created till 31 March, 2015. On the basis of the above-mentioned facts, the Committee notes that the querist has contended that the power plants are functioning at the level of not at intended capacity. Moreover, the other irrigation network has been completed at a level which does not give 100% of its anticipated capacity but are functioning at sub optimum level. On this basis, the querist has
contended that the power project and the relevant asset have not been completed 'substantially' and therefore, these should not be capitalised in the books of account. Thus, the Committee notes that the issue to be examined is the point of time at which the cost of the relevant assets of the project should be capitalised. In this regard, the Committee notes the following requirements of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the ‘Rules’):

“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.

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 above provisions require a fixed asset (comprising the plant) to be capitalised once it is ready to commence commercial production. The Committee is of the view that the date when an asset 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 project and other facilities, the quality and the quantity of the output produced, etc. 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, then the costs should be capitalised even if it is not achieving targeted or

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2 The opinion should be read in the context of Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’, which has been revised as AS 10, ‘Property, Plant and Equipment’ by the Companies (Accounting Standards) Amendment Rules, 2016 vide Ministry of Corporate Affairs (MCA) Notification No. G.S.R. 364(E) dated 30.03.2016.
100% production. The Committee further notes that what is important is when the project is ready to commence commercial production and not the intended capacity to be achieved. In this regard, the Committee also notes paragraphs 21 and 22 of Accounting Standard (AS) 16, ‘Borrowing Costs’, notified under the ‘Rules’, which although addresses the issue from the point of view of the borrowing costs, however, the Committee is of the view that the principle enunciated in these paragraphs can be applied to other expenditures also. Paragraphs 21 and 22 of AS 16 are reproduced below:

“21. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.”

From the above, the Committee is of the view that those units/parts of the project which are ready for their intended use and can be operated independently of the remaining units/parts, should be considered to be ready for commencement of commercial production/intended use. In this context, the Committee notes that in the extant case, the project is functional although at sub-optimal level and the company has started generation of power, from which income is also being recognised. Accordingly, it appears to the Committee that although the project may not be substantially complete to operate at its intended capacity and the components/units of the project are interdependent and interlinked (as being contended by the querist), since the project is functional and can be operated for its intended use as mentioned above, it can be considered to be ready to commence commercial production and therefore, relevant asset(s) of the project should be capitalised.
16. With regard to the issue raised by the querist relating to breaking of the project into different units of account in case of capitalisation of the project, the Committee is of the view that those units/parts of the project which are ready for their intended use and can be operated independently of the remaining units/parts, should be capitalised as and when these are so ready, as discussed in paragraph 15 above using appropriate heads and classification, considering the requirements of Schedule II and Schedule III to the Companies Act, 2013. In this context, the Committee also wishes to point out that once the relevant assets are capitalised, depreciation should be provided on such capitalised asset(s) as per the provisions of Accounting Standard (AS) 6, ‘Depreciation Accounting’, notified under the Rules.

17. In the context of expenditure incurred subsequent to capitalisation since the project is still under implementation and activities to reach the intended capacity of the project are still in progress, the Committee notes the following paragraphs of AS 10, notified under the Rules:

“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.”

From the above, the Committee is of the view that the subsequent expenditure on the project should be evaluated for capitalisation as per the above-reproduced requirements of AS 10. If the expenditure incurred increases the future benefits from the existing asset beyond its previously assessed standard of performance, e.g., an increase in capacity, it should be capitalised and if it becomes an integral part of the existing asset, it should be included in the gross book value of the existing asset.
D. Opinion

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

(i) The fixed asset/project should be capitalised once it is ready to commence commercial production. Since in the extant case, the company has started generation of power, from which income is also being recognised, it appears to the Committee that the project is functional and can be operated for its intended use as mentioned above. Accordingly, it can be considered to be ready to commence commercial production and therefore, relevant asset(s) of the project should be capitalised, as discussed in paragraph 15 above.

(ii) The units/parts of the project which are ready for their intended use and can be operated independently of the remaining units/parts, should be capitalised as and when these are ready, as discussed in paragraph 15 above using appropriate heads of assets, considering the requirements of Schedule II and Schedule III to the Companies Act, 2013, as discussed in paragraph 16 above.

(iii) The identified units of account should be capitalised as and when these are ready to commence commercial production irrespective of the fact that these are functioning at sub-optimal capacity and not at intended full capacity. Subsequent expenditure on the project should be evaluated for capitalisation as per the requirements of AS 10, as discussed in paragraph 17 above.

(iv) Answer to this question does not arise in view of (ii) and (iii) above.
Query No. 16

Subject: Treatment of royalty paid in dispute, pending the final decision of the Court.

A. Facts of the Case

1. Royalty on production of crude oil, casing head condensate and natural gas is paid to Central Government (for production from offshore fields) and to State Governments (for production from onshore fields) in terms of the statutory provisions of Oilfields (Regulation and Development) Act, 1948 (ORDA), Petroleum & Natural Gas (PNG) Rules, 1959 and Notifications issued thereunder from time to time.

2. Upto March’98, petroleum sector was under Administered Pricing Mechanism (APM) wherein, the price of indigenous crude oil produced by oil producers (the company and other similar companies) was determined on the basis of operating cost and 15% post tax return on capital employed. Till March’98, under APM regime, royalty on crude oil in the Schedule to ORDA was fixed by the Government of India at specific rate in Rupees per metric tonne.

3. In the year 1997, the Government of India vide Resolution dated 21st November, 1997 decided phased programme of dismantling of APM from petroleum sector starting from 01st April, 1998 and to be completed by 31st March, 2002. It was decided that cost-plus formula is withdrawn for indigenous crude oil producers and the price receivable by oil producers will be linked to increasing percentage of international crude prices in a phased manner i.e., domestic price would be equivalent to pre-announced percentage of weighted average free on board(FOB) price of actual imports of crude oil during the transition period (April’98 till March’02). However, royalty rates continued to be specific upto March’02.

4. In terms of Government of India Resolution dated 21st November, 1997 and Resolution dated 28th March, 2002, petroleum products were decontrolled in the following manner:

   (i) Consumer prices of all products except MS (petrol), HSD (diesel), Aviation Turbine Fuel (ATF), SKO (kerosene) for PDS and LPG for domestic crude were decontrolled w.e.f. 01.04.1998.

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1 Opinion finalised by the Committee on 1.2.2016.
(ii) Pricing of ATF decontrolled w.e.f. 01st April, 2001.

(iii) Consumer prices of HSD (diesel) and MS (petrol) to be market determined w.e.f. 01st April, 2002.

(iv) The subsidies on a specified flat rate basis on PDS Kerosene and domestic LPG to be borne by Consolidated Fund of India from 01st April, 2002. These subsidies to be phased out in the next 3 to 5 years.

Vide Resolution dated 28th March, 02, following was also decided:

(i) The Oil Coordination Committee (OCC) will be wound up w.e.f. 01st April, 2002.

(ii) A Cell, by the name of ‘Petroleum Planning and Analysis Cell (PPAC)’ will be created under the MoP&NG effective 01st April’02 to assist the Ministry.

5. Meanwhile, keeping in view the proposed reform process in the hydrocarbon sector, i.e., Proposed dismantling of Administered Pricing Mechanism (APM), a Committee headed by Shri J.M. Mauskar, Joint Secretary (Exploration) in the Ministry of Petroleum & Natural Gas (MoP&NG) was constituted in the year 2000 for evolution of a new scheme of royalty w.e.f. 1.4.1998.

6. Based on the recommendations of the Mauskar Committee, the new Scheme effective from 01.04.1998 was circulated vide Resolution dated 17th March, 2003. Salient features of the Resolution dated 17th March, 2003 are as under:

(i) Royalty will be fixed on Ad valorem basis.

(ii) Royalty will be calculated on cum-royalty basis.

(iii) A deduction of 7.5% and 10% of the crude oil price considered for onland and offshore production respectively will be made in order to determine the wellhead price.

(iv) For the period 01.04.98 to 31.03.02, royalty @ 20% will be paid on the wellhead price derived and calculated on the basis of notified percentages of weighted average FOB price of actual
import of crude oil stipulated in Government Resolution on dismantling of the APM.

(v) With effect from 01.04.02, the wellhead price of crude oil as derived from the market driven price obtained/obtainable by the producers based on ‘arm’s length transactions’ will be considered for royalty calculations.

(vi) For onland areas, royalty will be paid @ 20% of the wellhead price till the year 2006-07. The convergence process would commence w.e.f. the year 2007-08 with tapering rates of royalty @ 1.5% each year so as to facilitate convergence with New Exploration Licensing Policy (NELP) rates of 12.5% by the year 2011-12. For offshore areas, royalty will be paid @ 10% of the wellhead price.

(vii) The requisite notifications, orders etc. to implement the above decision will be issued separately. (Emphasis supplied by the querist)

Mechanism of sharing of under-recoveries - Extension of discounts by the company:

7. Meanwhile, international oil prices began to rise steeply from the year 2003-04 (during the year 2002-03, average price of Indian Basket of crude oil was around US$ 27/bbl, which rose upto US$ 39/bbl in the year 2004-05). In order to protect the interests of common man from the uncertainties of rising international oil prices, it was decided that the Public Sector Oil Marketing Companies (OMCs) will not increase the selling prices of PDS kerosene and domestic LPG (Petrol (MS) and Diesel (HSD) was also added in the year 2004-05) in commensurate to increase in international prices. As a result, OMCs began to incur under-recoveries on sale of these products. Accordingly, based on the decision taken at the level of Union Cabinet, a mechanism for sharing the under-recoveries of OMCs was evolved by the Government of India during the year 2003-04 wherein it was decided that such under-recoveries of OMCs would be shared among upstream and downstream companies. The same was communicated by the Government of India vide its letter dated 30 October, 2003. As per the mechanism, it was decided that the contribution from upstream companies would come in terms of discounts on the prices of crude oil, LPG and Kerosene supplied by them to OMCs. The salient features of the mechanism are given below:
(a) OMCs would strive to make up for about 1/3rd of the projected under-recoveries by cross-subsidisation through other retail products.

(b) The balance under-recoveries of OMCs, after accounting for over-recoveries from other retail products, would be equally shared amongst the OMCs and upstream sector companies (including the company).

(c) The amount of under-recovery of each OMC to be made good by the upstream sector would be equal to half of the balance under-recoveries.

(d) The contribution from the upstream sector companies would come in terms of appropriate discounts on the prices of crude oil, Domestic LPG and PDS kerosene supplied by them to OMCs.

(e) Contribution of upstream sector companies would be broadly in the ratio of each company’s PAT (profit after tax).

However, Government while communicating the mechanism directed that revenue of State Governments in terms of royalty on crude oil should not be affected by the discount.

(Emphasis supplied by the querist.)

8. In view of above directives, effective from April’03, the company started extending discount on sale price of crude oil and realised only sale price net of discount. Accordingly, the company started paying royalty on production of offshore crude oil to the Central Government at post-discount sale price (i.e., actual sale price realised by the company). However, in view of specific directive from Government of India, the company paid royalty to State Governments including Government of Gujarat on production of onshore crude at pre-discount (notional) sale price. (Emphasis supplied by the querist.)

9. As brought out at paragraph 5 above, aforesaid Resolution dated 17.03.2003 was issued keeping in view complete dismantling of APM and realisation of international prices to domestic crude producers, viz., the company and other such producers. However, as explained above, though, complete dismantling of APM from hydrocarbon sector was envisaged, it could not happen, as the Government of India effective from the year 2003-04, started regulating prices of petroleum products of vital importance of
common man viz., LPG domestic and PDS kerosene (HSD and MS from the year 2004-05). Consequently, the Government of India started directing the company and other oil companies to extend discounts from the sale price in respect of crude oil supplied to refineries, i.e., started regulating net realised prices of domestic crude oil also.

10. As provided in Resolution dated 17th March'03, Government of India issued Notification dated 16th December'04, which substituted Schedule under section 6A of ORDA for regulation of payment of royalty. Relevant portion of Notifications dated 16th December, 2004 pertaining to rates of royalty in respect of nomination blocks awarded to National Oil Companies (NOCs) viz., the company and other oil companies is reproduced below:

“1 (1) B(ii) With effect from 1.4.2002:

(a) Onland areas: @ 20% of Well Head Price

...

Note1: Well Head Price of Crude Oil and Casing Head Condensate for areas covered under 1. (1) B. and 2. (1).B. above will be determined by deducting 7.5% and 10% of the Crude Oil and Casing Head Condensate price considered for onland and offshore production respectively.

Royalty will be calculated on cum–royalty basis as under:

Royalty Amount = (Well Head Price × Royalty Rate)/(100+Royalty Rate)"

It is pertinent to mention that in view of the fact that complete dismantling could not happen, as envisaged at the time of submission of Mausker Committee Report, following vital recommendations of Mausker Committee (which was incorporated in the Resolution dated 17th March'03) were not incorporated for implementation in the Notification of 16th December'04:

“(a) consideration of the wellhead price of crude oil as derived from the market driven price obtained/ obtainable by the producers based on ‘arm’s length transactions’ for royalty calculations and

(b) the process of tapering of royalty rate so as to facilitate convergence with NELP rates of 12.5% by 2011-12”

(Emphasis supplied by the querist.)
11. Subsequently, Government substituted earlier Note in respect of methodology for determination of wellhead price from sale price vide Notification dated 20th August'07, wherein it was decided that the wellhead price of crude oil for nomination blocks of the company and other oil companies shall be determined by deducting Rs. 1,251/MT and Rs. 947/MT for onshore and offshore respectively from the sale price of crude oil. (Emphasis supplied by the querist.)

12. To sum up, presently, royalty on crude oil produced from onland fields is payable @ 20% of well-head price, wherein well-head price is determined by deducting Rs. 1,251/MT and post well-head levies from the sale price of crude oil. (Emphasis supplied by the querist.)

13. Meanwhile, since the company was realising only post-discount sale prices on sale of crude oil but paying royalty to State Governments on pre-discount sale prices, as per the specific directive from Government of India, it resulted into an uncharacteristic situation wherein the statutory ceiling of 20% royalty fixed under section 6A of ORDA was breached. The company in fact paid royalty in excess of 20% and sometimes as high as 50% of sale price at well-head. Consequently, the company made various representations to the Government of India to review their directives of payment of royalty to State Governments including the Government of Gujarat at pre-discount prices so as to ensure compliance of statutory provisions. (Emphasis supplied by the querist.)

14. Subsequently, keeping in view the statutory provisions of the Oilfields (Regulation and Development) Act 1948, Petroleum & Natural Gas Rules, 1959, notifications issued there-under and the company’s representation, and after consulting the Ministry of Law, the MoP&NG vide its letter dated 23rd May, 2008 withdrew its earlier directives issued vide letter dated 30th October, 2003 regarding payment of royalty to State Governments at pre-discount prices. Consequently, the company started making payment of royalty at post-discount price from 01st April, 2008 (due on 31st May, 2008) to state governments (including the Government of Gujarat) as per the provisions of ORD Act and also in line with royalty payment to the Central Government. (Emphasis supplied by the querist.)

Demand of royalty on pre-discount price by Government of Gujarat:

15. Initially, the Government of Gujarat issued demand notices to the company with a request to pay differential royalty (royalty on pre-discount
less royalty on post-discount) from April'08 onwards, which were suitably replied by the company.

16. Subsequently, the Government of Gujarat also represented to the Central Government. In reply, Central Government had clarified to the Government of Gujarat that the decision taken by the Central Government for payment of royalty on post-discount prices is the result of a thorough examination of the matter considering various statutory provisions in consultation with the Ministry of Law.

17. The Government of India, MoP&NG vide letter dated 05 November, 2009 had clarified that:

(a) The mechanism under which upstream oil companies issue price discounts to OMCs is not their internal arrangement but decisions taken at the level of the Union Cabinet from time-to-time.

(b) The burden sharing mechanism effective from 2003-04 is still in vogue and offering of discounts is not a post-sale event. As explained, discounts are calculated and communicated by Government on a quarterly basis.

(c) During the years 2003-04 to 2007-08, royalty on onshore crude was paid by the company on pre-discount prices on the specific directive from Government, which was subsequently, reviewed and modified, keeping in view the provisions of ORD Act and P&NG Rules.

18. In September’11, Government of Gujarat filed Special Civil Application (SCA) No.13943/2011 before the Gujarat High Court against MoP&NG and the company, seeking the following reliefs:

— To set aside the letter dated 23.5.2008 of MoP&NG

— To direct the company to pay the royalty on pre-discounted price of crude oil w.e.f. April, 2008.

(Emphasis supplied by the querist)

19. Vide judgment dated 30.11.2013, the Gujarat High Court accepted the stand of Government of Gujarat. High Court relied on resolution dated 17.3.2003 which notified the recommendations of the Mauskar Committee,
and held that after the said resolution, the basis of royalty would be the market-driven price arrived at from arms’ length transaction. It was held that the directions of MoP&NG asking the company to give discounts to OMC were an internal matter and it could not be at the cost of the Government of Gujarat. High Court directed the company to make payment of royalty on pre-discounted price and make the payment of shortfall within two months. (Emphasis supplied by the querist)

20. Aggrieved by the order of Gujarat High Court, the company challenged the said order dated 30.11.2013 by filing SLP before the Supreme Court of India wherein the Government of Gujarat and MoP&NG have been made respondents. Hon’ble Supreme Court vide order dated 13.02.14 (copy of the order has been supplied by the querist for the perusal of the Committee), admitted SLP of the company, issued notice to respondents and directed them to file counter affidavits within 2 months and granted stay against the order dated 30.11.2013 of Gujarat High Court on the condition that the company pays royalty to the Government of Gujarat on pre-discounted price of crude oil w.e.f. 1.2.2014.

21. In terms of said order, the company has started paying royalty to the Gujarat Government on pre-discount price w.e.f. February’14 in respect of crude production from Gujarat. Differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) paid to the Gujarat Government as per Supreme Court interim order dated 13.02.2014 is accounted and shown as deposit with the Government of Gujarat. During the year 2014-15, there is no fresh development in the matter and the matter is still pending with Hon’ble Supreme Court. It is also understood that till date, respondent(s) have not filed any counter affidavit(s) (as desired by the apex court). Meanwhile, the company continued paying royalty on pre-discount price to the Government of Gujarat in terms of interim order dated 13.02.14 of Supreme Court. Total amount paid to the Government of Gujarat in terms of Supreme Court order dated 13.02.14 towards differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) w.e.f. February’14 to March’15 works out to Rs. 2,107 crore which has been shown as deposit.
22. Accounting treatment:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Period</th>
<th>Description</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td></td>
<td>Royalty on actual post-discounted sale price paid to Gujarat Government</td>
<td>Charged to statement of profit and loss</td>
</tr>
<tr>
<td>2.</td>
<td>2008-09 till 2013-14</td>
<td>Differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) demanded by Government of Gujarat (estimated to Rs. 11,633 crore)</td>
<td>Shown as contingent liability</td>
</tr>
<tr>
<td>3.</td>
<td></td>
<td>Royalty on actual post-discounted sale price paid to Gujarat Government</td>
<td>Charged to statement of profit and loss</td>
</tr>
<tr>
<td>4.</td>
<td>February’14 to March’15</td>
<td>Differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) paid to Gujarat Government as per Supreme Court interim order dated 13.02.2014 (amounting Rs. 2,107 Crore)</td>
<td>accounted and shown as deposit with Government of Gujarat</td>
</tr>
</tbody>
</table>

Recent judgment of Supreme Court dated 03.08.15 in the matter of demand of sales tax on pre-discount price by the Government of Gujarat:

23. As explained above, effective from April’03, the company started extending discount on sale price of crude oil and realised only sale price net of discount. Accordingly, the company paid sales tax/ VAT to the respective State Governments including the Government of Gujarat on sale of crude oil at post-discount sale price, i.e., actual sale price realised by the company. However, during the process of sales tax assessments for the years 2004-05 and onwards, Gujarat Sales Tax Authorities disallowed the discounts given by the company to oil marketing companies (OMCs) on sale of crude oil, LPG (Domestic) and SKO (PDS) in terms of directives from MoP&NG for sharing of under-recoveries of OMCs. As a result, assessment orders were issued raising demand of significant amount of sales tax, interest and penalty
thereon. The estimated liability was to the tune of Rs. 2,482 crore approx. for the period from 2004-05 to September, 2014. (Emphasis supplied by the querist.)

24. The company filed appeals with the concerned first Appellate authority but the matter was decided against the company. Subsequently, appeals were filed with the Gujarat VAT Tribunal. The Gujarat VAT Tribunal vide its order dated 19.09.2013 also upheld the view of Gujarat VAT Department. However, the Hon’ble High Court of Gujarat vide its order dated 18.12.2014 reversed the judgment of Gujarat VAT Tribunal and allowed the appeal in favour of the company.

25. Against the aforesaid Order of Hon’ble Gujarat High Court, the Gujarat VAT Department filed an SLP before the Hon’ble Supreme Court. SLP was mentioned in the Apex Court on 03.08.15. The Hon’ble Supreme Court vide its order dated 03.08.2015, dismissed the SLP filed by Department. Accordingly, the issue of payment of sales tax has now been settled at the level of Apex court. As a result, it has been established that the actual post-discount price realised by the company is the sale price for the purpose of payment of sales tax. (Emphasis supplied by the querist)

B. Query

26. During the pendency of the judgment of Hon’ble Supreme Court and keeping in view its interim order dated 13.02.2014, the querist has sought the opinion of the Expert Advisory Committee as to whether the company is correct in showing as deposit, the amount of Rs. 2,107 crore paid to the Government of Gujarat towards differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) for the period from February’14 to March’15 in terms of Supreme Court order dated 13.02.2014 or whether the company should adopt any other accounting treatment.

C. Points considered by the Committee

27. The Committee notes that the basic issue raised by the querist relates to whether the company is correct in showing as deposit, the amount of Rs. 2,107 crore paid to the Government of Gujarat towards differential royalty (royalty on pre-discount sale price less royalty on post-discount actual sale price). The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case,
such as, treatment of actual royalty paid by the company, accounting for differential royalty during the year 2008-09 till 2013-14 demanded by the State Govt. as contingent liability, treatment of disputed sales tax, interest and penalty, etc. Further, the Committee wishes to point out that its opinion is expressed purely from accounting perspective and not from the perspective of interpretation of legal enactments, such as, the Oilfields (Regulation and Development) Act 1948, Petroleum & Natural Gas Rules, 1959, court orders, various Resolutions of the Government of India and notifications, scheme of royalty, etc.

28. The Committee notes from the Facts of the Case that the company is disclosing the differential amount of royalty during the period 2008-09 till 2013-14 demanded by the State Government as ‘contingent liability’. It is also noted that for the financial year ending 31st March, 2015, the differential royalty paid vide order of the Supreme Court has been accounted for and shown as ‘deposit’. Further, it is noted from the financial statements contained in the Annual Report (2014-15) of the company as supplied by the querist that for the financial year ended 31st March, 2015, the company continues to disclose the disputed obligation as its contingent liability along with the disclosure of the differential royalty paid as ‘deposit’.

29. With regard to the accounting for the amount paid towards differential royalty, the Committee notes the interim order of the Supreme Court, directing the company to pay the differential royalty amount to the State Government from February 2014 as follows:

“Pending further orders from this Court, operation of the impugned judgement shall remain stayed subject to the condition that the Appellant – the company pays royalty to respondent no. 1 – State of Gujarat on pre-discounted price of crude oil w.e.f. 1st February, 2014 onwards.”

From the above, the Committee is of the view that direction of the Court to pay the differential royalty to the State Government w.e.f. 1st February, 2014 and not with effect from 2008-09 indicates that the order is only an interim order pending the final judgement. In case the decision of the Supreme Court is in favour of the company, the amount deposited shall be refundable to the company, whereas, if the decision goes against the company, the amount paid would be adjusted against the liability of the company. Thus, the amount paid is akin to a deposit with the Government. Accordingly, the Committee is of the view that as on 31st March, 2015, apart
from the compliance with the requirements of Accounting Standard (AS) 29, ‘Provisions, Contingent Liabilities and Contingent Assets’, the company should recognise the payment made against the disputed liability as ‘deposit’ which should be classified under an appropriate accounting head, considering the requirements of Schedule III to the Companies Act, 2013. However, the company should appropriately explain the fact of the dispute either through appropriate nomenclature, for example, ‘Deposit of royalty paid in dispute’ or through an appropriate disclosure in the Notes to Account so as to disclose the nature of the item and to give a true and fair view to the users of the financial statements. In this regard, the Committee noted from the financial statements contained in the Annual Report (2014-15) of the company that the company has explained the item ‘Deposits’ by way of a note under notes to financial statements that the differential royalty has been paid as per the interim order of the Supreme Court, which is further explained by way of note to the contingent liabilities. The Committee is of the view that the aforesaid disclosures appear to be appropriate.

D. Opinion

30. On the basis of the above, the Committee is of the opinion that as on 31st March, 2015, apart from the disclosure as contingent liability, as discussed in paragraph 28 above, the company should recognise the payment made against the disputed liability as ‘deposit’ which should be classified under an appropriate accounting head, considering the requirements of Schedule III to the Companies Act, 2013, as discussed in paragraph 29 above. However, the company should appropriately explain the fact of the dispute either through appropriate nomenclature, for example, ‘Deposit of royalty paid in dispute’ or through an appropriate disclosure in the Notes to Account so as to disclose the nature of the item and to a give a true and fair view to the users of the financial statements. Since the company has made such disclosures, as discussed in paragraph 29 above, the accounting treatment followed by the company appears to be correct.
Query No. 17

Subject: Application of paragraph 21 of AS 22.

A. Facts of the Case

1. A company is a public limited company listed with recognised stock exchanges, engaged in manufacturing of cementitious material on Pan India basis (hereinafter referred to as the ‘company’). The company follows calendar year. In Union Budget for the financial year 2015-16 presented on 28th February 2015, the Government has revised the surcharge on income tax from 5% to 10%, resulting in increase of effective ‘Corporate Tax’ rate from 33.99% to 34.61%.

2. The querist has stated that as per Accounting Standard (AS) 22, ‘Accounting for Taxes on Income’, companies are required to recognise deferred tax on its temporary difference between book income and taxable income as per prescribed rate. Paragraph 21 of AS 22 says “deferred tax should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.” According to the querist, as per Accounting Standard, it is important to note that the enactment or substantive enactment should have taken place by the balance sheet date. Enactment is when a bill is passed by both houses and receives consent of the President. It is important to note that the enactment or substantive enactment should take place by the balance sheet date, for example, if an enterprise has a December year end, the Finance Bill presented subsequently in February is neither an enactment nor a substantive enactment because it did not occur by the balance sheet date.

3. The querist has stated that the company is in the process of finalisation of its quarterly accounts for the quarter ended March 2015. Its board meeting for consideration and approval of results is scheduled on 29th April 2015. In order to finalise quarterly results for March 2015, the company has to decide the meaning of the word used in AS 22, ‘substantive enactment’. What is ‘substantive enactment’? At which point of time, substantive enactment should be considered / triggered. Whether substantive enactment of the Finance Bill 2015 (Budget) took place on the balance sheet date.

\footnotetext[1]{Opinion finalised by the Committee on 1.2.2016.}
4. The querist has explained various stages for approval of Finance Bill as follows:

- Presenting the Finance Bill on the floor of house.
- Passing of Finance Bill at Lok Sabha
- Passing of Finance Bill at Rajya Sabha
- Passing of Finance Bill at lok Sabha and Rajya Sabha both + assent of the President is accorded

Further, the querist has also mentioned various possible situations where substantive enactment of Finance Bill may be considered:

- Substantive enactment where the Government is having majority in both the houses:
  - Can substantive enactment be considered by merely introduction of the Finance Bill on the floor of the house or,
  - Can substantive enactment be considered only when Finance Bill is passed by Lok Sabha
  - Can substantive enactment be considered only when Finance Bill is passed by both the houses

- Substantive enactment where the Government is having majority in one house and not in another house, considering Finance Bill need to be compulsory presented in Lok Sabha, first:
  - Government has majority in Lok Sabha but not in Rajya Sabha
    Can substantive enactment be considered when Finance Bill is passed by Lok Sabha only and not by Rajya Sabha
  - Government has majority in Rajya Sabha but not in Lok Sabha
    Can substantive enactment be considered merely by passing of Finance Bill by Lok Sabha only

The querist has stated that in all above situations, it is assumed that the President's assent will be certain.
5. According to the querist, the following approach, viz., conservative versus aggressive approach, should be considered while deciding on above question:

- Be aggressive in booking of expenses and defer recognition of revenue part
- If there is increase in effective tax rate in Finance Bill, the company should recognise the impact of the same immediately, without considering ‘substantive enactment’ principles, since there is exposure to that extent and otherwise in case there is decrease in effective tax rate.

6. **Accounting treatment of change in effective tax rate:**

The querist has also raised a question that in case of change in effective tax rate, what treatment should be given to opening deferred tax position, viz., whether it should be taken to free reserves or to the statement of profit and loss. For example, Companies Act, 2013, has made changes and it has changed the way depreciation was charged till date. All the companies need to apply these changes retrospectively. Here option is given to take the impact of depreciation till last year either in the statement of profit and loss of current year or adjust the same in retained earnings.

**B. Query**

7. In the above background, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

   (i) What is substantive enactment for the purposes of 31st March, 2015 accounts? Is presenting the budget on the floor of the house a substantive enactment? Is passing of the bill by the Lok Sabha (not by Rajya Sabha) a substantive enactment? Is passing of the bill by the Lok Sabha and Rajya Sabha (Presidents consent not yet received) a substantive enactment?

   (ii) In case of change in effective tax rate, what treatment should be given to opening deferred tax position. Should it be taken to free reserve or to the statement of profit and loss?
C. Points considered by the Committee

8. The Committee notes that the basic issues raised by the querist relate to application of paragraph 21 of AS 22 in relation to meaning of ‘substantive enactment’ in the context of corporate tax rate, for finalisation of quarterly accounts of the company for quarter ended March 2015 and accounting treatment for effect of change in effective tax rate. Accordingly, the Committee has considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, impact of following calendar year as the accounting year, etc. Further, while expressing its opinion, the Committee is laying down the principles to be followed in cases where a revision in tax rates has been announced/introduced but the same has not yet been enacted.

9. The Committee notes from the Facts of the Case that the company follows calendar year as the accounting year for the purpose of preparation of financial statements. Further, in Union Budget for the financial year 2015-16 presented on 28th February 2015, the Government has revised the surcharge on income tax from 5% to 10%, resulting in increase of effective ‘Corporate Tax’ rate from 33.99% to 34.61%. However, till finalisation of quarterly accounts of March 2015, the revision has not yet been enacted (e.g., President’s assent has not yet been accorded). Accordingly, the issue that arises is whether in such situation, can such proposed revision in tax rates be considered as substantively enacted for recognition of deferred taxes as per AS 22. In this regard, the Committee notes the following requirements of AS 22, notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the ‘Rules’) as follows:

AS 22

“21. Deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

...”

“22. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws.”
From the above, the Committee notes that in case certain changes are proposed in tax rates, the term ‘substantively enacted’ should be construed as the tax rate that has the substantive effect of actual enactment. In other words, the process of enactment is substantively complete. The Committee is of the view that whether the process of enactment is substantively complete is a matter of judgement, which should be determined considering the facts and circumstances and various factors, such as, whether or not the remaining stages of the enactment process in past have affected the outcome (i.e., enactment of surcharge in the extant case) and are likely to do so in the present situation, viz., the process remaining to be executed for enactment is more of a procedural formality and is not expected to affect the outcome, etc. For example, in most cases, a tax rate for the purposes of AS 22 is regarded as having been substantively enacted if the Bill containing such changed tax rate has been passed by the Lok Sabha and is awaiting passage through the Rajya Sabha and the President’s assent. The Committee is also of the view that adequate and appropriate disclosures should be made regarding the tax rate adopted while recognising deferred tax assets and liabilities and the basis for such adoption in the notes to accounts.

10. With regard to accounting impact of changes in effective tax rates in the next reporting period resulting into any increase or decrease in the recognised deferred tax assets or liabilities, the Committee notes the requirements of Accounting Standard (AS) 25, ‘Interim Financial Reporting’ and Accounting Standard (AS) 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’, notified under the Rules, as reproduced below:

**AS 25**

“29. To illustrate:

... 

c income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes.”
“16. An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

... (d) the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;

...”

“25. If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

26. Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Paragraph 16(d) of this Standard requires similar disclosure in an interim financial report. Examples include changes in estimate in the final interim period relating to inventory write-downs, restructurings, or impairment losses that were reported in an earlier interim period of the financial year. The disclosure required by the preceding paragraph is consistent with AS 5 requirements and is intended to be restricted in scope so as to relate only to the change in estimates. An enterprise is not required to include additional interim period financial information in its annual financial statements.”

AS 5

“5. All items of income and expense which are recognised in a period should be included in the determination of net profit or
loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates."

From the above, the Committee is of the view that the income tax rate applied in an interim period is an accounting estimate and effects of any change in such estimates resulting into income or expenses in another reporting period should be recognised in the statement of profit and loss. Further, paragraphs 16(d), 25 and 26 of AS 25 also requires disclosure in the interim financial report or financial statements (for final interim period in case separate financial report is not prepared for that period) of the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year if such changes have material effects in the current interim period. In this regard, the Committee also wishes to point out that any adjustment to free reserves or retained earnings is possible only if there is any specific requirement in the accounting standard(s) or law to do so.

D. Opinion

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

(a) The term ‘substantively enacted’ should be construed as the tax rate that has the substantive effect of actual enactment. In other words, the process of enactment is substantively complete and whether the process of enactment is substantively complete is a matter of judgement, which should be determined considering the facts and circumstances and various factors as discussed in paragraph 9 above.

(b) Effects of changes in effective tax rates in the next reporting period resulting into any increase or decrease in the recognised deferred tax assets or liabilities should be recognised in the statement of profit and loss and not in free reserves, as discussed in paragraph 10 above.
Query No. 18

Subject: Determination of the average net profit for the purpose of incurring Corporate Social Responsibility (CSR) expenses and disclosure of CSR expenses in the financial statements.¹

A. Facts of the Case

1. A corporation (company) is a Central Public Sector Undertaking (CPSU) under the Ministry of Textiles. During the course of audit of accounts by the office of Comptroller and Auditor General of India (C&AG), the audit team commented that for calculating average profit of the company during three years for the calculation purpose of Corporate Social Responsibility (CSR) expenses, the loss suffered in any preceding three financial years should not be considered and it should be treated as zero. Further, it has also been observed by them that CSR expenses should be disclosed as a separate line item on the face of the profit and loss statement. (The query raised by the office of C&AG and management reply thereon have been supplied by the querist for the perusal of the Committee.)

2. However, the querist has stated that in pursuance to the provisions of section 198 of the Companies Act, 2013, while calculating the amount to be spent on CSR activities, the corporation has adjusted the loss suffered in the financial year 2013-14 against the profit earned in the financial years 2011-12 and 2012-13. The expenditure incurred on CSR was shown as separate line item under the head of administrative expenses of the statement of profit and loss.

3. The office of the C&AG has desired that opinion from the Institute of Chartered Accountants of India (ICAI) may be obtained to ensure adequate provision towards CSR activities and disclosure of the same in the statement of profit and loss.

B. Query

4. In view of the above, the querist has sought the opinion of the Expert Advisory Committee on the following:

   (a) Whether negative profit (loss) suffered during the three immediately preceding financial years is to be treated as zero for

¹ Opinion finalised by the Committee on 1.2.2016.
the purpose of arriving at 2% of the average net profit of the company for incurring CSR expenses

or

the average so required shall be arrived at after adjusting the negative profit, i.e., loss against profit of the company.

(b) Whether the CSR expenses incurred are to be shown as separate line item on the face of the profit and loss statement or a separate line item under the note of Administrative Expenses’.

C. Points considered by the Committee

5. The Committee notes that the basic issues raised in the query relate to whether in case of loss incurred in a year, profit should be taken as zero or as a negative balance while calculating the average net profit for the purposes of incurring CSR expenses and the disclosure of CSR expenses in the statement of profit and loss. 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, determination of the amount to be spent on CSR activities as per the requirements of Companies Act, 2013, etc. At the outset, the Committee wishes to point out that the opinion expressed hereinafter is purely from accounting perspective and not from the perspective of interpretation of legal enactments, such as, Companies Act, 2013 or Rules made thereunder, etc.

6. With regard to the first issue raised as to whether profit should be taken as ‘zero’ or as a negative balance while computing average net profit of the company for incurring CSR expenses, the Committee notes the requirements of the Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India, as follows:

“11.03 Net Loss

See Net Profit

11.04 Net Profit

The excess of revenue over expenses during a particular accounting period. When the result of this computation is negative, it is referred to as net loss. The net profit may be shown before or after tax.”
From the above, the Committee notes that in the accounting parlance, the result of computation of revenue over expenses during a period, even though negative, is referred to as ‘net profit’. Thus, the Committee is of the view that from accounting perspective, average net profit should be arrived at after adjusting the negative profit, i.e., loss against profit of the company.

7. With regard to the second issue raised relating to the disclosure of CSR expenses in the statement of profit and loss, the Committee notes the requirement of the Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities, issued by the Institute of Chartered Accountants of India, as follows:

“16. Item 5 (A)(k) of the General Instructions for Preparation of Statement of Profit and Loss under Schedule III to the Companies Act, 2013, requires that in case of companies covered under Section 135, the amount of expenditure incurred on ‘Corporate Social Responsibility Activities’ shall be disclosed by way of a note to the statement of profit and loss. From the perspective of better financial reporting and still be in line with the requirements of Schedule III in this regard, it is recommended that all expenditure on CSR activities, that qualify to be recognised as expense in accordance with paragraphs 10-14 above should be recognised as a separate line item as ‘CSR expenditure’ in the statement of profit and loss. Further, the relevant note should disclose the break-up of various heads of expenses included in the line item ‘CSR expenditure’.”

From the above, it is clear that from the perspective of better financial reporting, the Guidance Note recommends that the company should disclose the CSR expenditure as a separate line item in the statement of profit and loss. However, if the company does not disclose CSR expenditure as a separate line item in the statement of profit and loss; instead includes it under another appropriate head(s) in the statement of profit and loss and explains it by way of a note in the notes to the financial statement, it would also be in accordance with the requirements of Schedule III to the Companies Act, 2013. In this context, the Committee notes that the company is including the CSR expenditure under the head ‘administrative expenses’ in the statement of profit and loss and disclosing its details in the notes to the financial statements. The Committee is of the view that CSR expenses should be included under an appropriate head in the statement of profit and loss, for example, ‘other expenses’ and not ‘administrative expenses’.
On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 4 above:

(a) For the purpose of arriving at 2% of the average net profit of the company for incurring CSR expenses, from accounting perspective, the average profit so required should be arrived at after adjusting the negative profit, i.e., loss against profit of the company, as discussed in paragraph 6 above.

(b) From the perspective of better financial reporting, the Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities recommends that the CSR expenses incurred should be shown as a separate line item in the profit and loss statement. However, if the company does not disclose CSR expenditure as a separate line item in the statement of profit and loss; instead includes it under another appropriate head(s), for example, ‘other expenses’ in the statement of profit and loss and explains it by way of a note in the notes to the financial statement, it would also be in accordance with the requirements of Schedule III to the Companies Act, 2013. Further, the CSR expenditure should not be included under the head ‘administrative expenses’ in the statement of profit and loss, as discussed in paragraph 7 above.
ADVISORY SERVICE RULES OF THE EXPERT ADVISORY COMMITTEE
(Applicable w.e.f. 1st April, 2014)

1. Queries should be stated in clear and unambiguous language. Each query should be self-contained. The querist should provide complete facts and in particular give the nature and the background of the industry or the business to which the query relates. The querist may also list the alternative solutions or viewpoints though the Committee will not be restricted by the alternatives so stated.

2. The Committee would deal with queries relating to accounting and/or auditing principles and allied matters and as a general rule, it will not answer queries which involve only legal interpretation of various enactments and matters involving professional misconduct.

3. Hypothetical cases will not be considered by the Committee. It is not necessary to reveal the identity of the client to whom the query relates.

4. Only queries received from the members of the Institute of Chartered Accountants of India will be answered by the Expert Advisory Committee. The membership number should be mentioned while sending the query.

5. The fee charged for each query is as follows:
   
   (i) Rs. 75,000/- plus service tax (as applicable) per query where the query relates to:

   (a) an enterprise whose equity or debt securities are listed on a recognised stock exchange, or

   (b) an enterprise having an annual turnover exceeding Rs.50 crore based on the annual accounts of the accounting year ending on a date immediately preceding the date of sending the query.

   (ii) Rs. 37,500/- plus service tax (as applicable) per query in any other case.

   The fee is payable in advance to cover the incidental expenses. Payments should be made by crossed Demand Draft or cheque or Postal Order payable at Delhi or New Delhi drawn in favour of the Secretary, The Institute of Chartered Accountants of India.
6. Where a query concerns a matter which is before the Board of Discipline or the Disciplinary Committee of the Institute, it shall not be answered by the Committee. Matters before an appropriate department of the government or the Income-tax authorities may not be answered by the Committee on appropriate consideration of the facts.

7. The querist should give a declaration in respect of the following as to whether to the best of his knowledge:

(i) the equity or debt securities of the enterprise to which the query relates are listed on a recognised stock exchange;

(ii) the annual turnover of the enterprise to which the query relates, based on the annual accounts of the accounting year immediately preceding the date of sending the query, exceeds Rs. 50 crore;

(iii) the issues involved in the query are pending before the Board of Discipline or the Disciplinary Committee of the Institute, any court of law, the Income-tax authorities or any other appropriate department of the government.

8. Each query should be on a separate sheet and five copies thereof, typed in double space, should be sent. The Committee reserves the right to call for more copies of the query. A copy of the query may also be sent on a floppy or through E-mail at eac@icai.in

9. The Committee reserves its right to decline to answer any query on an appropriate consideration of facts. If the Committee feels that it would not be in a position to, or should not reply to a query, the amount will be refunded to the querist.

10. The right of reproduction of the query and the opinion of the Committee thereon will rest with the Committee. The Committee reserves the right to publish the query together with its opinion thereon in such form as it may deem proper. The identity of the querist and/or the client will, however, not be disclosed, as far as possible.

11. It should be understood clearly that although the Committee has been appointed by the Council, an opinion given or a view expressed by the Committee would represent nothing more than the opinion or view of the members of the Committee and not the official opinion of the Council.
12. It must be appreciated that sufficient time is necessary for the Committee to formulate its opinion.

13. The queries conforming to above Rules should be addressed to the Secretary, Expert Advisory Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi- 110 002.